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ORGANIZATIONAL AND ECONOMIC IMPACTS"**

RELATORE:

CH.MO PROF. FRANCESCO ZEN

LAUREANDO: SERGHEI LISNIC

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Introduction

At the present stage of historical progress, the ensuring of a healthy and safe activity of financial markets represents a must for each state in the world. The progressive pace of the economic globalization and the penetration of the exotic contracts into various sectors of the economy (as in the case of derivatives) may pose a new challenge for the regulators. The financial crisis of 2007-2008 has surfaced the limitations of the market, making them more prominent in the wake of the havoc that the crisis inflicted. After the crisis, effects of which are still felt even in the present days, Regulators have been forced to review the then existing regulations, and fill in the existing gaps.

To the establishment of uniform standards of regulation of market was given a tremendously high importance on the international level. It became clear that prior to the financial crisis, the poor regulation allowed the banks much more freedom than reasonable.

Since then, many financial regulators around the globe have implemented lots of change, to ensure a healthy environment. The changes were concerned with Basel III that required a higher capital level for the banks as well as a higher liquidity ratio also enforcing banks to hold better-quality assets.

The change was forced not only on the banks - the main cause of the financial crisis, but also on the financial markets. As European Commission stipulates, the new changes “*aimed at making financial markets more efficient, resilient and transparent, and at strengthening the protection of investors*”. On one hand the global market ensures the development of economy, and provides possibilities of retirement investment programs but, on the other hand, the uncertainty in the field of global finance may carry serious risks, since is the area of sharp and unpredictable up and downs. Here’s why it became indispensable to implement the much needed change and make the market efficient again.

Chapter 1 : The European Union – the fundamentals of regulations

Since the founding of the European Union (hereinafter “EU”) - an aftermath of the II World War, besides its other goals such as stopping the bloody wars among neighbors, had to also ensure an economic cooperation between them. This required the creation of a set of regulations – that subsequently evaluated into Markets in Financial Instruments Directive (MiFID) - whose purpose was explicitly to govern and harmonize this financial cooperation between members of the EU.

For countries within EU, at a supranational scale, the functions to regulate the stock market are carried out by the European System of Central Banks (ESCB), headed by the European Central Bank (ECB). *“The European Central Bank, whose statutes were specified in the Maastricht Treaty, has much greater independence today than its members’ national central banks had [before the joining in] with respect to the determination of monetary policy and lending to the government [...] but has higher transparency than did the national central banks of the twelve euro-area countries in 1998.”* (Crowe & Meade, 2007)

Together with the Committee of European Securities Regulators (CESR) – who has taken on the task to adapt each country’s legislation to the directive, the European Agency for the securities market supervision (ESMA), which is subject to European the Commission and the EU Council.

The history of legal regulation of the stock market in the formation of European integration could be divided into three periods:

- 1) the initial period (1979-1988).
- 2) the establishment of a single domestic securities market (1989-1998).;
- 3) during the creation of a comprehensive regulatory framework (1999-2010.).

The first directive, dedicated to the regulation of the stock market, was adopted by the Council of Europe in 1979. In 1989, it was first adopted the Directive in accordance with the new procedure and the authority established by the Single European Act; further

development of the process in the second period due to the Maastricht Treaty that declared as its aim to be completing the creation of the single market for goods and services. In 1999 was approved the Action Plan in the sphere of financial services, which critically assesses the state of the securities market in the EU and provides a set of measures for the development of this market; all further progress in this direction is associated with the implementation of the Plan in the framework of the Lamfalussy process 1;

Nonetheless, the prototype of today's regulations was the Investment Services Directive (ISD), that has provided a healthy legislative framework for the European Area in the investment domain.

1.1 Investment Services Directive (ISD)

Adopted in 1993, the directive Nr. 93/22/EEC of 10 May 1993 on investment services in the securities field, a.k.a Investment Services Directive (hereinafter “**ISD**”) had represented the conclusion of a critical chapter in the new realities of the EU, and has been described as “*granting a passport for EU securities firms to conduct cross-border operations anywhere in the EU based on a license issued by their respective home states.*” (Manning Gilbert Warren III, 1994). The clashes of different regulations and business cultures of twelve member states² had brought up the questions of creating one set of rules and provisions to simplify the trade between them. The EU Council of Ministers³ had, if not solved, then at least side-stepped the existing, at the time, problems, and adopted on May 10, 1993 the aforementioned document with its major provisions for all Member states being:

¹ It means that the MiFID is being adopted using a legislative approach known as the "Lamfalussy Process." It was named in the honor of the President of the Committee who first conceptualized and introduced it in 2001. "Lamfalussy" Directives are split into levels – the "level 1" Directive establishes the guiding principles of the legislation agreed in co-decision by EP/Council, the "level 2" implementing measures implemented by European Commission, and the third and fourth level. The advantage of this "split-level" approach is that it allows the Council and Parliament to focus on the key political decisions, while technical implementing details are worked through afterwards. This flexibility allows for more rapid and frequent adaptation of the legislation so that it can keep pace with market and technological developments.

² In 1993 the EU had been formed of 12 countries, with the subsequent joining, during the years, of another 16 countries. As of the year 2016 the EU is formed of 28 member states, Croatia being the last one to join in 2013.

1. To reduce, or wholly eliminate the need for license requirement or authorizations among the states;
2. allow the firms to freely operate across Europe with the authorization received from their home state, thus ensuring mutual recognition of the license by other states, without requesting any local regulatory approvals;
3. establish standards and rules in order to ensure a healthy and sound financial environment;

Thanks to this document all the major financial institutions were able to open their offices in other countries and provide their services abroad. However, with time going by, the increasing expansion and versatility of the market led to the need to create and implementation a more detailed regulation.

The ISD had only represent the first step, as stipulated in many different studies, and although many of the scholars, who touched the subject of the ISD, stated that the directive at hand had a limited impact and success, it still managed to set the course toward bigger changes and toward regulatory harmony in the EU securities market at that time, still they specified that it was “*merely a first step in integrating the securities markets and in achieving the goals of investor protection and efficient functioning of markets [and if] EU wants to reach full integration, it must develop a stronger foundation that encourages flexibility and a proactive approach to regulation.*” (Smith, 2000)

ISD was perceived as a cornerstone for the EU regulation, but due to the fact was created in the era when the linkage between the markets was in seldom use, the level of ISD coverage might have been enough. The directive had lacked the provisions for investment advice, and an optimal level of investor protection. With the time going by, it was becoming more and more obvious the directive is failing to provide a clear enforcement and supervision within EU, thus requiring to be updated or substituted.

The most significant steps in the development of the investment market were made in 2002, when the EU Member States had initiated the convening of the conference to consider

ways to improve the quality of regulation in the finance sphere. The natural result of this was the development in 2004, the special directives in the field of finance.

1.2 Toward MiFID – the process of implementation in Italy

When speaking about MiFID, we have to bear in mind that we do not refer only to only one directive, but a directive that is built in levels:

➤ First, in 2004, 21st April the Council together with the European Parliament are adopting the Directive nr. 2004/39/EC (that will be recognized as *first level*), named The Markets in Financial Instruments Directive, usually addressed to as MiFID, which was an overall the next step in the reaching the regulatory harmony to which the European Union Member States were struggling to arrive. It came with the purpose to substitute the previously adopted Investment Services Directive (ISD) in order to strengthen and reinforce the efficiency of financial markets in the EU area.

➤ Two years later, 2006 on 10th of August, it subsequently adopts the Directive nr. 2006/73 / EC that is named the Implementing Directive (*second level*), carrying down the measures for the implementation of the first level directive nr. 2004/39/EC. The last directive was adopted with the role of specifying the technical measures and requirements together with operating procedure for the companies.

The last directive was adopted with the role of specifying the technical measures and requirements together with operating procedure for the companies.

On the same day, together with the directive, it was issued also Implementing Regulation Nr. 1287/2006 that defined the modality of implementing the MiFID directive in the domains like: market transparency, requirements for admission

of the financial instruments to being traded on the market, requirements concerning certification etc.

The Regulations was applicable in every state member, and will prevail in the case of a conflict with the National laws.

- The *third level*, was the work of The Committee of European Securities Regulators (CESR) that working together with national authorities, has issued in January 2007 general as well as specific principles for the adoption and implementation of the directive. The deadline for the implementation of MiFID in for each member state was fixed for 31st of January 2007.

Italian authorities had subsequently pressed on with the implementation of the directive, and until the end of March, same year; the Italian Ministry of Economy and Finance already publishes the modification in the Consolidated Law on Finance (*it. Testo Unico della Finanza* - abrv. TUF). Two months after the Italian Parliament charges the Government to make the necessary amendments for the proper enforcement of MiFID, assigning Bank of Italy, together with CONSOB⁴, to supervise the correct enactment of the later.

As such, on November 1st 2007 the two Financial authorities had issued specific regulations and provisions for the successful implementation European Directive on Investment Services (MiFID) in Italian legal frameworks.

1.3 The reasoning behind MiFID implementation.

MiFID represents a comprehensive document who's aim was *“to improve the competitiveness of EU financial markets by creating a single market for investment services*

⁴ Bank of Italy, together with CONSOB had defined, under Art.5 of Consolidated Law on Finance a “protocol” that indicates to each supervisory authority their tasks, and how to conclude them. The protocol is intended to guarantee the coordination of supervisory authorities, in order to reduce the burdens of the intermediaries.

and activities, and ensuring a high degree of harmonized protection for investors in financial instruments, such as shares, bonds, derivatives and various structured products”⁵. It represented a new legal framework, implemented in order to substitute the outdated ISD, extending its regulation to the products not covered by ISD, strengthening its the latter’s provisions and introducing regulations for the areas not covered yet.

ISD has permitted the countries to use the “concentration rule” which stated that the retail orders are bound to be processed on a regulated market, which had a tremendous impact on the competition. MiFID’s provisions had canceled this rule, allowing regulated market and other trading platforms to compete for the order flow.

The Directive also provided information on various arguments, such as: regulating the free movement of capital and investment within the EU, delineating the requirements for organized trading platforms and over-the-counter (OTC) trading systems and other, obliging financial institutions to include a wide range of regulations – to which they are obliged to adhere to when providing investment services – as well as raise awareness of the investors themselves.

Each of the EU member-states may set their own supervisory institution and set their own rules and requirements, but the activities are bound to be consistent the MiFID Directive.

The document also provides harmonized rules for the three countries not part of European Union but part of European Economic Area - Iceland, Norway and Liechtenstein.

The requirements of MiFID can be summarized as follows:

➤ Developments in market structures and organizational requirement

With the ever progressing financial world, it shortly became obvious that Investment Services Directive adopted so far as 1993 was extremely outdated. For example, the same “passport system”, first settled by ISD, was in desperate need of an update and new rules for the monitoring of firm that use the passport, in order to erase barriers in extra-national trading and ensure supplementary competition.

⁵Source: <http://ec.europa.eu>

Moreover, with the rise of alternative trading techniques and functionalities, it became acutely necessary to substitute the ISD, and provide a more updated, adapted and firm set of regulation.

➤ Systematic Internalization & Pre-Trade and Post-Trade Transparency.

It is necessary to have a proactive analysis of the transparency regime for instruments other than shares.

➤ Best execution

MiFID has also set up provisions demanding the banks or other financial institutions to ensure that the orders received from clients would be executed at most favorable and profitable terms, and reach the best possible result.

➤ Client classification

The directive identifies 3 types of clients: professional, retail and eligible counterparty. The degree of protection that the client enjoys is determined by its classification.

➤ Transaction Reporting

MiFID enlarges the requirements for reporting the transaction of all instruments that are admitted to be traded on Regulated Market.

➤ Conflicts of Interest

The directive requires each company to take into account the possibility of occurrence of a conflict of interest between the company and its clients. It is required to take any steps, within reason, as to prevent such situation.

In the instance that situation occurred, it is expected to have effective arrangements as how to manage the situation.

➤ Client Adequacy and Appropriateness

The companies operating in the field of investments advisory and portfolio management, are henceforth required to perform a “suitability test” so as to assess, besides the financial objectives of the client, also the level of experience and knowledge in the matter at hand.

For any other services, companies are bound to ensure that their products/services are fitting not only the client’s necessities, but also its familiarity with the subject.

As stated, MiFID is a key part of a complex system, vital for regulating the processes in the world market and that is bound to also be consistent with all relevant worldwide standards and regulations. Within a relatively short period of time in the European market it has been a positive dynamics of development. The most prominent is a significant reduction in the cost of financial services, resulting in greater market attractiveness for investment. In addition, there was finally idea of how a regulated market should actually look like, which contributed to the development of new regulations aimed at improving the performance of financial transactions.

The interactions of market participants became more transparent, moreover that they were provided with the necessary level of legal protection. The principle of action of MiFID was to create a strong market to attract investors, which is only possible with full transparency of transactions on the exchange.

Disregarding the fact that MiFID was actually expected with a bit of criticism, it did in fact represented a very important step in market legislation, substituting 25 different regulatory regimes with a harmonized set of rules (Casey, Lanoo 2006). Some have argued that, even if it had a tremendous impact on the investors, not only wholesale, but retail ones as well, it lacked the cost-benefit analysis in the phase of preparation of MiFID’s implementation, and the one that was done by other institutions has still proved to have been inefficient. (Skinner, Knight, 2007 p. 207).

Cost-benefit analysis (CBA) was indeed necessary to be performed in order to better understand and forecast the repercussions of such an important change within the regulation

system. The Commission stated that the CBA was not required to be performed when the work on the level one Directive has started. Moreover, assessing the impact of MiFID as a stand-alone legislation has proven to be very difficult, if not impossible in such a complex market. Nonetheless, in November, 2002, London Economics⁶ has performed a major study that was able to quantify the major benefits for the macro-environment, and the benefits were quite positive, although the beneficial effect of the regulations integration and modification were deemed “positive but underestimated”, hinting that the effects were much more successful than forecasted⁷.

Later, in 2010, the company London Economics were commissioned by City of London, to perform a research for better understanding MiFID’s impact, and the results showed that *“the macroeconomic outcomes expected by the 2002 London Economics study may well have been largely realized. Overall, MiFID is estimated to have raised the long-run level of EU GDP (at constant prices) by about 0.7% to 0.8% percent.”* (London Economics, 2010)

Skinner and Knight stated that MiFID had its own shortcomings. They argue in their book *“The Future of Investing in Europe's Markets after MiFID”* (2007) that the levels of protection differ across EU. They make the example of UK regulation, that will be enacted whenever a problem of investment arises, but only in the cases when the product was bought or sold through a company that’s quartered in the UK. Whenever the company is situated outside the UK, there might be problems concerning which of the countries’ regulation will step in. Even if under MiFID there are some arrangements put in place, they are quite “loose” comparing to UK regulations, which might considerable breach the financial safety of an inexperienced investor. The principle of equivalence will not necessarily bring the benefit of the benefit of same level protection in all EU countries.

⁶ *“The Report about Macro-Economic Impact of of EU Financial Markets”* (2002) has been performed together with PricewaterhouseCoopers and Oxford Economic Forecasting, who presented positive results to the integration of European capital market and make it “whole”.

⁷ European Commission - Press Releases, MEMO/07/439 of 29th of October 2007, Brussels.

On the bigger scale, after the adoption and implementation of MiFID, there could be noticed a positive trend in the EU market development. Here are some of the positive aspects of the implementation MiFID requirements:

- 1) MiFID has contributed to the creation of a single market, so that the participants were given more favorable conditions;
- 2) The stakeholders, after being consulted⁸ had stated that the implementation has beneficially impacted the trading costs, and increased the pre-trade transparency. Nonetheless, in their opinion, the best execution rule has proven to be poorly effective.
- 3) As expected – it has increased competition among the investment service companies.
- 4) It increased investor's protection, particularly the retail clients.
- 5) Better level of protection of investments – due to the fact that organizations were required to sort out the clientele into certain categories, they needed to know the level of clients' knowledge of the financial sector, which has served as the main factor in providing a more appropriate service to the clients.

1.4 MiFID under Regolamento Intermediari of CONSOB

Pre-MiFID

Traditionally, the Italian stock market was poorly regulated. However, at the end of the 1980s, Italy, the same as in other European countries, has carried out a regulatory reform. Its aim was to make the stock market meet modern requirements. Under this reform was created

⁸ In the London Report “*Understanding the Impact of MiFID in the Context of Global and National Regulatory Innovations*” stated above updated with the post-MiFID period analysis year 2009 (excluding 2008 due to the fact that the year at hand was highly instable due to the crisis), specified that, in order to complement the empirical data, was conveyed a survey of MiFID impact on the investors. The results showed that overall the stakeholders positively influenced by the Directive implementation.

the Italian Commission for the Stock Market (it. Commissione nazionale per le società e la borsa; hereinafter “**CONSOB**”).

CONSOB was included of an important participant in regulating the financial sector of the European regulatory process. Under the articles of Law and Constitution has been issued the „*Consolidated Law on Financial Intermediation*” (CLFI) (it. Testo Unico della Finanza), with the intent to harmonize and bring together all the normative and provisions previously adopted during the years.

„It [CLFI] provides comprehensive regulation of securities intermediaries, financial markets and central depositaries of financial instruments and issuers. The provisions governing intermediaries confirm the principle of assigning supervisory responsibilities to objective, entrusting the Bank of Italy with safeguarding financial stability and CONSOB with ensuring transparent and proper conduct. The bank of Italy is also charged with defining the prudential rules for limiting risk that investments undertaking must follow”

Bank of Italy, 1999 p.171 cited by Howell, 2004, p. 165

CONSOB works together with Bank of Italy (Banca d'Italia) which, in addition to performing standard functions of a country’s central bank, also plays an important regulatory role in the financial market of Italy, being charged with overlooking the activities of market participants and assuring a good functioning of the market.

Its main purposes were to monitor the implementation of market participant’s legislation, thus ensure “*transparency and correct behavior by financial market participants*”, being authorized to request market participants to provide information. In case of some doubts or breach of regulations, it was also authorized to inspect and sanction the market participants. Annually CONSOB reports on its activities to the Ministry of Economy and Finance of Italy.

The main law regulating the activities of the stock market has become the Consolidated Law on Finance of 24 February 1998, legislative decree Nr. 58 which summarized the legislative framework for all the changes and concerns all the activity on the stock market, the types of investment institutions (intermediaries), issuance of securities, corporate

governance, securities trading, regulatory authorities, the organization of the stock exchange etc. This law included the main provisions of the EU ISD directive.

Until the early 1990s, the regulatory system was of an institutional nature: the Bank of Italy controlled the banks, CONSOB - securities companies, ISVAP⁹ (Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo) - the insurance companies, the Commission on pension funds (Commissione di vigilanza sui fondi pensioni) controlled the pension funds.

Post-MiFID

After the adoption of MiFID, as specified before, CONSOB and Bank of Italy were both charged with issuing regulations in order to implement MiFID's provisions in Italy. These provisions entered into force on 2007, November 2nd.

Particularly CONSOB, with Bank of Italy's consent, approved regulations concerning the two authorities, for assuring a correct MiFID enactment. The arrangements were more of a *procedural and organizational nature*, also concerning the conflicts of interest.

Separately, Bank of Italy had touched the subject of regulating the Minimum Capital Requirements and Italian investment firms' foreign operations (it. Società di Intermediazione Mobiliare SIMs).

CONSOB has gone forward adopting resolution no. 16191 of 29/10/2007 on the financial market (substituting Regulation n. 11768 of 23 December 1998), and resolution no. 161910 of 29/10/2007 (amending Regulation nr: 11522 of 1st of July 1998) issuing the "*Intermediaries Regulation*" which ensured coverage of financial market, intermediaries,

⁹ ISVAP was a public Italian institution founded in 1982, that has replaced the Ministry of Industry taking over his duties as a supervisory institution who's tasks was to oversee the private insurances, brokers and insurance agents on the rules of Legislative Decree n. 209/05 – also called Insurance Code. Afterwards, under the decree nr. 95 of 6th of July, 2012 was substituted with Istituto per la vigilanza sulle assicurazioni (IVASS).

non-EU investments firms and SIMs authorization. The regulation furnished provisions for EU companies that operated and offer investment services on Italian ground.

Nowadays it is stated that the regulation is functional, instead of carrying a more institutional character, due to the fact that the market is supervised by many agencies at once. Trying to characterize the modern regulation system of Italy, compared to other important EU members, we can conclude that it's a system of diarchy¹⁰ – with Bank of Italy and CONSOB holding the two positions. As a matter of fact, art. 5 of Consolidated Law on Finance (*it.* T.U.F) specifies that the two authorities are not only bound to collaborate but also to operate in a coordinated manner as to reduce the burden fallen upon authorized persons.

Following the MiFID directive, CONSOB has outlined a very articulated and thorough supervision for ensuring that the companies comply with the newly adopted standards when providing investment services. It had a particular regard to the financial services distribution.

In years preceding the implementation of MiFID much of the litigation in the field of investment services related to the carelessness with which the principle of “adequacy” of financial investments was treated. Only after the implementing the Directive that the rule has undergone significant changes, having to now distinguish between "Suitability" and “Appropriateness" of operations.

¹⁰ In the Consolidated Law on Finance could be noticed a constantly repeated phrase, stating that certain actions are carried out "by the Bank of Italy, after consulting Consob" or " Consob, after consulting the Bank of Italy".

Chapter 2 : From MiFID I to MiFID II

Even if the first Directive had overall improved the situation on the investment market and has managed to remove the barriers in Europe, with the crisis that hit in 2008 it became obvious that the first Directive has become inefficient. As stated by the European Commission - “*while MiFID created competition [...] and brought more choice and lower prices for investors, shortcomings were exposed in the wake of the financial crisis*”¹¹. The financial crisis¹² has managed to expose regime’s weaknesses - the poorly-efficient market transparency, its lack in the non-equities market, and was in need for revision of existing laws which became too old for the all progressing market

The impact of the subprime mortgage crisis had a tremendous impact which undermined the stability in the markets, had significantly affected the investors’ confidence in the system, such that in order to ensure that the laws and the progress are walking hand-in-hand, the European Commission decided to take action and, with the participation of the G-20¹³ members, have made some changes to the existing at the time Directive. Afterwards, with several innovations, the new Directive became a kind of a “follower” to the previous document.

Timeline

On 20th of October, 2011, the European Commission had published the new proposals for the new Directive, and new Regulation - MiFID II (*Market in Financial Instruments Directive II 2014/65/EU of the European Parliament and of the Council*) and MiFIR (*Regulation Nr. 600/2014 of the European Parliament and of the Council*). After 3 years, in 2014 on 15th of April the Council of the European Union has adopted the final (Level 1) texts

¹¹ Source: <http://ec.europa.eu>

¹² “*The global financial crisis of 2007–2008 was the most severe since the Great Depression of the 1930s. Some of the world’s best-known financial institutions collapsed or were nationalized, while many others survived only with massive state support*” Its main cause was the “*opacity of OTC derivatives, and the concentration of risk in large and interconnected firms*” – source:

¹³ G20 is an informal group of 19 countries and the European Union, with representatives of the International Monetary Fund and the World Bank,

for the two documents. In June the two texts were published in the Official Journal and on 2nd of July they entered into force. ESMA has been bound to provide and publish Guidelines and Technical Standards, until finally on 28th of September 2015 it submitted the Final Report to the Commission, containing the final draft of 28 technical standards, including 27 regulatory technical standards (*RTS*) and one implementing technical standard (*ITS*). During the years the implementation of the new Directive and Regulation into the national laws has been set as of 3rd of July, 2017. As for today the application of MiFID II and MiFIR had been postponed until 3rd of January 2018.

Structure

Just as MiFID I, the second directive is structured in levels:

1. *Level 1* is known as the primary legislation, which came in force in 2014, July, being represented by two distinctive documents explained above – MiFID and MiFIR – widely known as the Directive and Regulation. Altogether, these documents could be invoked as “MiFID II”. The Regulation (MiFIR) does not need to be implemented separately in each EU member state, since it is enforceable by default, quite the opposite from the Directive (MiFID II) – where all the state members are bound to adopt the new legislation into their own laws and regulations.

2. *Level 2* often referred to as the “*detail level*”, is quite crucial for healthy functioning of the new legislation, mainly because it contains the technicalities and measures that supplement the newly updated framework. It’s represented by two forms of documents:
 - The *Technical standards* – that are first outlined by ESMA and, later on, approved by European Commission. They are subsequently divided into two types of standards:
 - Regulatory Technical Standards (RTS)
 - Implementing Technical Standards (ITS)

- and the *Delegated acts* - this type of measures are initially outlined by the EC, with ESMA's advice, being as well divided into 2 types:
 - Delegated Directives (DD)
 - Delegated Regulations (DR)

The Delegated Regulations, being the core of MiFIR, have direct force, meanwhile the Delegated Directives are subject to transposition into national jurisdiction by each state-member.

3. Last, *Level 3*, often referred to as "*guidance level*" represents the recommendations from ESMA, due to the intricacy of the new frameworks, and possible future discrepancies that might arise, the third level provides a sort of guidance, and answer to possible questions.

Purpose

Official Journal of the European Union defines the new Directive and Regulation purposes as follows:

“The new legal framework governs the requirements applicable to investment firms, regulated markets, data reporting services providers and third country firms providing investment services or activities in the Union. It harmonizes the position limits regime for commodity derivatives to improve transparency, to support orderly pricing and to prevent market abuse. It also introduces rules on high-frequency algorithmic trading and improves the oversight of financial markets by harmonizing administrative sanctions. Building on the rules already in place, the new legal framework also strengthens the protection of investors by introducing robust organizational and conduct requirements.”

Official Journal of European Union, 2016

The new Directive and Regulation has brought forth a great number of changes, in the wake of the 2008 financial crisis.

As specified above the changes were focused upon strengthening the financial framework of European Union, allowing the country members to have a healthy investment environment. It has made a particular reference to the following issues:

- a) It establishes a framework for the structure of the market, covering pre-existing spaces, ensuring that trading is carried out mainly on regulated platforms.
- b) They acted upon the so called “*dark markets*” or “*dark pool*” trading¹⁴, thus trading outside the regulated market, on the markets set up either by banks or specialized investment firms. This markets flourished under the MiFID I framework, that contained nothing to keep this type of trading at bay, a shortcoming that was argued to have triggered the global financial crisis.
- c) They have focused on the derivatives regulation, especially those that were, until then excluded, forcing the contracts to be traded on a regulated market (RM), multilateral trading facility (MTF) or organized trading facilities (OTF).
- d) MiFID II sets increased requirements for transparency of the equity market and, for the first time in the history of financial regulation, transparency principle also applies to instruments where the underlying asset - are borrowed funds, thus derivatives. The transparency regime was expanded for the pre- and post-trade period, extending it to non-equity instruments, despite the fact that according to their features might be possible a pre-trade transparency waiver for large orders.
- e) Strengthening the process of information consolidation in order to reduce the negative effects of the trade fragmentation.

Despite the fact the new regulation is brought to change the present one, and to bring order in the investment market, its implementation might be quite difficult. The Directive’s implementation was postponed a couple of times, due to the fact the companies are having difficulties to adjust under the new requirements.

¹⁴ “*Dark pool*” trading - it’s an enormous unregulated financial market (platform) that gives the opportunity to trade without disclosing any information (anonymously) and without publishing prices or quantity of the traded instruments. *Dark pool trading* is frequently used by large traders (investors) for setting huge deals in total anonymity. Besides the benefit of anonymity, the dark pool traders also are able to diminish costs and avoid the market-impact.

More about the “dark pool” trading – please refer to Scott Patterson’s book “*Dark Pools: The Rise of the Machine Traders and the Rigging of the U.S. Stock Market*” (2013)

On the 10th of February 2016, the European Commission has decided to postpone the date of application of the new Directive's package for an extra year¹⁵, fixing the deadline to 3rd of January 2018. This decision was taken as to give the banks and investment companies enough time to prepare for the new market rules. Not only the regulators, but also all market participants have to implement and follow an exceptionally difficult set of rules and they would require more time to be able to meet them.

As specified by the EU the decision was taken *“The reason for the extension lies in the complex technical infrastructure that needs to be set up for the MiFID II package to work effectively. The European Securities and Markets Authority (ESMA) has to collect data from about 300 trading venues on about 15 million financial instruments. To achieve this result, ESMA must work closely with national competent authorities and the trading venues themselves. However, the European Commission was informed by ESMA that neither competent authorities, nor market participants, would have the necessary systems ready by 3 January 2017, the date by which the MiFID II package was initially scheduled to become operational. In light of these exceptional circumstances and in order to avoid legal uncertainty and potential market disruption, an extension was deemed necessary.”*. (EC, 2016)

2.1 Main changes

The European Commission defines a list of 7 main key elements that changed under the new legislation. All of the main key elements are presented below:

1. **Market structure framework: trading venues - RM, MTF and OTF**

In relation to shares and financial instruments whose underlying asset is a debt capital, they introduced an obligation to be traded only on regulated trading platforms. Investment

¹⁵ The new MiFID II package was expected to enter into application already on 3rd of January 2017. This was the day set by the European Commission to for the new Directive to become operational. This date was subsequently postponed due to extremely difficult package requirements, such that the neither the companies nor the regulators would've succeeded to be ready for in time.

companies using an internal matching system¹⁶ performing customer orders for shares, depositary receipts, and funds traded on the stock exchange certificates and other similar financial instruments on a multilateral basis, etc. must obtain the status of Multilateral Trading Facility (hereinafter “**MTF**”). These rules are intended to establish the same standards for RM and MTF.

Outside the two previous markets, they also created the Organized Trading Facility (hereinafter “**OTF**”), the third type of multilateral system, where the buying and selling can interact in the system, and are able to enter in a contract. OTF markets will be limited in trading only the derivatives, structured finance product, bonds and emission allowances being prohibited to trade in equity instruments.

Each of the system is bound to have similar market monitoring and organizational provisions, meanwhile their transparency regimes would have to be adjusted to the specific instruments they’re trading in. There’s an important detail though: when trading on the OTF the investor has to explain why he wants his trade to be executed on the OTF, and not RM or MTF instead.

Key differences between trading venues:

	<i>RM</i>	<i>MTF</i>	<i>OTF</i>
<i>Financial instruments</i>	Equity and non-equity	Equity and non-equity	Non-equity only
<i>Execution of transactions</i>	Non-discretionary	Non-discretionary	Discretionary
<i>Proprietary capital</i>	Prohibited	Prohibited	Prohibited, with exceptions
<i>Matched principal trading</i>	Prohibited	Prohibited	Permitted in some cases with client consent

¹⁶ *Internal matching system* – systems constituted inside investment companies or banks, under which the buy and sell orders are matched inside this system,

<i>Own account trading</i>	Prohibited	Prohibited	Permitted with respect to illiquid sovereign debt instruments
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Table 2.1 Key differences between trading venues
Source: Linklaters, 2014¹⁷

Neutrality of the OTF operators should be ensured by limiting their ability to use their own capital. However, this provision is still too “broad” for use in practice, giving the opportunity to be omitted or worked-around, and is expected to be redefined in the future. This vagueness is said to be a deliberate assumption, which should provide a temporary flexibility to work with complex financial instruments such as derivatives on securities with fixed income. It is believed that in the future OTF have become leaders in the number of transactions with the advanced financial instruments, such as futures and options. At the moment, the main task of OTF is making transparency in transactions in the financial markets. Together with prohibiting the operators to use their own capital, they were also given the discretion in decision-making related with order execution.

Besides, the new Directive also revises the systematic internaliser (**IS**) regulation, introduced and addressed previously under the MiFID I regulation in 2007. A “*systematic internaliser*” under the first directive was explained as follows:

“*Systematic internaliser*’ means an investment firm which, on an organised, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF;”

MiFID I - Article 4 (7)

Under the new Directive the definition of a SI does not change much in essence, but there’s a slight difference that now a SI represents a company that trades outside the “*regulated market, an MTF or an OTF without operating a multilateral system;*”¹⁸. One of

¹⁷ Global law firm “Linklaters” paper on “*MiFID II: The new market structure paradigm*”, 2014

¹⁸ MiFID II – Article 4 (1) prov. 20

the things differentiating the SI from the other trading venues is the fact that it can execute the orders received from clients against its own capital. SI were defined by MiFID II not as a trading venues (such as RM, MTF, or OTF) but as a counter party:

“... any bilateral trading carried out with clients should be relevant and criteria should be developed for the identification of investment firms required to register as systematic internaliser. While trading venues are facilities in which multiple third party buying and selling interests interact in the system, a systematic internaliser should not be allowed to bring together third party buying and selling interests in functionally the same way as a trading venue.”

MiFID II – Recital 17

For instance, trading platforms where trading occurs always against a single investment firm is to be defined as a *Systematic internaliser*, only if it complies with the clauses specified by the directive. On the opposite, a platform where the traders interact with one another for the same instrument will be defined as *multi-dealer/multilateral platform*.

Schematically the new market framework could be defined as follows:



Figure 2.1 Market Structure post-MiFID II/MiFIR
Source: CONSOB¹⁹

2. Equity market transparency

¹⁹ Workshop sulle Misure di Livello 2 della MiFID II/MiFIR by Maria Antonietta Scopelliti., CONSOB publication 2014

The transparency issue was also addressed within the MiFID I, although some consider it to be only a fraction of the real issue. The decision to address the transparency topic more in-depth was mainly influenced by the events of summer 2007, when the subprime crisis took its origins. Due to the fact that the traded instruments did not fall under the regulation, such outcomes²⁰ became possible.

The new legislation is expected to increase the market transparency, to both class of assets: equity as well as non-equity ones, (such as derivatives and bonds).

Article 3 of MiFIR stipulates that

“Market operators and investment firms operating a trading venue shall make public current bid and offer prices and the depth of trading interests at those prices which are advertised through their systems for shares, depositary receipts, ETFs, certificates and other similar financial instruments traded on a trading venue. That requirement shall also apply to actionable indication of interests. Market operators and investment firms operating a trading venue shall make that information available to the public on a continuous basis during normal trading hours”

MiFIR – Article 3

Despite the fact transparency requirements are identical for the RM, MTF or OTF, they will be calibrated depending on the type of instruments being negotiated, and the type of “trading systems including order-book, quote-driven, hybrid and periodic auction trading systems.”²¹

Article 4 addresses the “*Waivers for equity instruments*” issue, specifying that the competent authorities may waive the obligation for market operators and investment firms only in strictly defined cases²², but are forced, before granting a waiver to inform and give explanation of the regulator (ESMA or other competent authority) about the waive they

²⁰ For more about the financial crisis and its impact please read “*Real Effects of the 2007-08 Financial Crisis around the World*” by Hui Tong (IMF) and Shang-Jin Wei (Columbia University and NBER)

²¹ MiFIR - Article 3 (1) to Article. 3 (2)

²² MiFIR - Article 4 (1) a-d

would presume to use and also provide all the information about the waiver. The regulators are then given the right to withdraw the waiver if they see fit.²³

3. Strengthened Supervisory Powers

The G20 multiple times expressed their concerns about the volatility and speculation in the commodity derivatives, and the impact it has on prices. The European Commission recognized the effects of such instruments and riskiness and stated that “*the Commission is now coming forward with a proposal to ensure that derivatives trading becomes more safe, sound and efficient.*”²⁴ Since then they decided to increase transparency for the commodity derivatives²⁵, giving the regulators the right to ban or limit the use, distribution and marketing of certain instruments. The companies will be, hence-forth, obliged to prove that the trading activities are indeed ancillary for their business. ESMA is charged with providing a calculation algorithm for giving the competent authorities a system under which to put limits on position and also introduce position management controls, as delineated Article 2 (4):

“ESMA shall develop draft regulatory technical standards to specify [...] the criteria for establishing when an activity is to be considered to be ancillary to the main business at a group level.”

MiFID II - Article 2 (4)

As specified before, ESMA will also be bound to provide the list of eligible instruments

²³ MiFIR - Article 4 (4) to Article. 4 (5)

²⁴ European Commission Press Release “*Measures on derivatives, Credit Default Swaps and short selling in financial markets*”, Wednesday 15 September 2010

²⁵ The term commodity is defined by MiFIR, which makes reference to point (44)(c) of Article 4(1) of MiFID II which states that the commodity derivative is “*any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures;*”

derivatives through a technical standard, and under the MiFID II Regulation it is also bound to pay its attention the derivatives previously excluded²⁶ from the regulation.

4. Increased competition

The European Commission recognizes the competition in the trading and clearing of financial instruments to be a cornerstone of a healthy functioning of the trading market, hence it has decided to provide a non-discriminatory access regime as delineated bellow:

“All trading venues, namely regulated markets, multilateral trading facilities (MTFs), and OTFs, should lay down transparent and non-discriminatory rules governing access to the facility.”

MiFID II – Recital 14

all the while abolishing any technical and legal restriction for any investment firms to join the RMs within the Union. MiFIR specify that all trading venues shall provide a non-discriminatory access to Central Counterparties (hereinafter “CCPs”), as follows:

“For effective competition between trading venues for derivatives, it is essential that trading venues have non-discriminatory and transparent access to CCPs.

Non-discriminatory access to a CCP should mean that a trading venue has the right to non-discriminatory treatment in terms of how contracts traded on its platform are treated in terms of collateral requirements and netting of economically equivalent contracts and cross-margining with correlated contracts cleared by the same CCP, and non-discriminatory clearing fees.”

MiFIR – Recital 28

²⁶ It concerns mainly the *energy derivatives*. This type of contracts was excluded from the previous regulation, and with the implementation of the new Directive, which made a too narrow definition and a “too strict approach in distinguishing physical products from financial instruments.” In their letter EURELECTRIC, the Association of the Electricity Industry in Europe, has expressed its concerns about the impact that this might have on the energy market, which could “undermine any ambitions of the Energy Union to reinforce competitiveness, sustainability and security of supply [and also] trigger unintended consequences”. (Eurelectric letter to European Commissioners of 10 April 2015). Until the 1st of January the European Commission will elaborate a report, together with ESMA, about the impact that MiFID might have on Energy market

Later (Recitals 38-40) on the Regulation provides with various details on the CCPs admission to the venues, specifying that the CCPs would be allowed only if “*if certain access criteria specified in regulatory technical standards are met.*”²⁷. Besides, the CCPs will now have to accept to clear transactions that “*transactions executed in different trading venues, to the extent that those venues comply with the operational and technical requirements established by the CCP, including the risk management requirements.*”²⁸.

Article 38 of MiFIR delineates that the third-country CCPs could gain access to a Union trading venue only if they would be set in the country which the MiFID II Directive has deemed appropriate in terms of “*effective equivalent system for the recognition of trading venues*”²⁹.

5. Controls for Algorithmic Trading and High Frequency Trading

It has been discussed a lot lately about the influence of the technologies on the trading market. The part of *High Frequency Trading* and *Algorithmic Trading* was in reality a cornerstone of MiFID’s II purpose, as has it been the focus of global regulatory attention for the past years. It is undoubtedly that the fast pace of technological progress rises concerns for the healthy functioning of the market. The literature has only begun to provide evidence about potential problems and risks of such manner of trading only after the events of 6th of May 2010, the date of an unmotivated collapse of the *Dow Jones, S&P 500 and Nasdaq Imposite* index. This collapse has caused the *Flash Crash*³⁰ - an important enough event to bring into public’s view the problems arising from HFT.

²⁷ MiFIR – Recital 38

²⁸ MiFIR – Recital 38-39

²⁹ MiFIR – Article 28 (1) d

³⁰ The *Flash Crash* – a stock market crash that took place on 6th of May, 2010. It has started at 14:32 and has lasted almost 36 minutes, during which period the *S&P 500, Dow Jones Industrial Average* and *Nasdaq Composite* had careened down and subsequently rebounded causing such big companies like General Electric and Proctor & Gamble to lose billions of dollars off their share prices, and causing massive panic on the market. The Dow Jones’ value has dropped for almost 9%, but the market subsequent rebounded settled at 3% lower at the closing time. The official report was issued by the Securities and Exchange Commission and the Commodity Futures Trading Commission that stated that the Flash Crash was allegedly caused by a *Waddell & Reed mutual fund*, which had issued a sell order for \$4.1bn, that started a “hot potato” effect.

There was heated academic debate over the HFT, but without reaching unique results. It was argued that HFT has as much of a negative impact on the market, as it does have some beneficial ones. Its positive impact could be recognized only after a careful examination of high-frequency trader's strategies. Despite the aggressiveness of such strategies, the manner of trading does not prove to not have any impact on others traders' profitability and also increases liquidity in the market³¹. However, under other aspects, it can raise doubts regarding the advantage that these systems allow against traditional traders.

A 2013 research³² published by Bank of Italy, showed that the presence of High-Frequency traders can present the following benefits for the market:

- Increase in liquidity available to market participants;
- Reduction of the average *bid-ask spread*;
- Reduction of transaction costs;
- Increase in the price information efficiency;
- increase in *inter-market* links;

Nonetheless, it remained undoubtedly true that High-Frequency Trading might have amplified the shock that arose from the tremendous sell order sent to the market, and played an important role in the Flash Crash, thus remaining a problem.

Such negative effects needed mitigation, hence the authorities had begun discussing possible instruments to limit the HFT impact on the market. Among these was more

For more information concerning the Flash *Crash*, its origins and outcomes please read the official SEC – CFTC Report - “*FINDINGS REGARDING THE MARKET EVENTS OF MAY 6, 2010*”

³¹ James Angel, Lawrence Harris and Chester S. Spatt in their research “*Equity Trading in the 21st Century*” (2010), had reached the conclusion that HFT can give the traders to avoid high transaction costs, so that “*The ability to trade at low cost allows high-speed traders to provide great liquidity to the markets. Their willingness to devote capital to buy when others desire to sell and vice versa smooths out the price effects of order imbalances and further reduces transactions costs for end investors.*”

³² Bank of Italy Occasional Papers Nr. 198 “*High Frequency Trading: una panoramica*” by Puro Alfonso – September 2013

informative obligations for high frequency traders, insertion of *circuit breakers*³³, or limiting the *tick size*³⁴.

The Directive has made attempts to subdue the possible collateral damage for the market's integrity. Article 4 of the Regulation defines the *Algorithmic Trading* and *High Frequency Trading* as follows:

“‘algorithmic trading’ means trading in financial instruments where a computer algorithm automatically determines individual parameters of orders such as whether to initiate the order, the timing, price or quantity of the order or how to manage the order after its submission, with limited or no human intervention, and does not include any system that is only used for the purpose of routing orders to one or more trading venues or for the processing of orders involving no determination of any trading parameters or for the confirmation of orders or the post-trade processing of executed transactions;

MiFIR –Article 4 (1) (39)

“‘high-frequency algorithmic trading technique’ means an algorithmic trading technique characterized by: a) infrastructure intended to minimize network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high-speed direct electronic access; b) system-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders; and c) high message intraday rates which constitute orders, quotes or cancellations; ”

MiFIR –Article 4 (1) (40)

MiFID II hence required companies undertaking such manner of trading to be registered as an investment firm, and receive authorization prior entering the market. Firm

³³ MiFID II – Recital 64

“Circuit breakers are market-based trading halts triggered by a potential price disruption and intended to avoid discontinuity in price movements. CBs can thus facilitate investor protection and help assure fairness in, and integrity of, markets. CBs can be split into two types: market wide and stock-specific, depending on whether trading is suspended across an entire trading venue, or for a single, or several single securities. Regulation and market practices on CBs differ significantly between the EU and US” - ESMA Report on Trends, Risks and Vulnerabilities, 2015

³⁴ MiFID II – Recital 6

By *tick size* is intended a price fluctuation, a minimum amount by which assets quoted price can move up or down.

conducting such activities are required to maintain a certain level of appropriateness to management of software, risk, and governance, and also comply with compulsory market-rules. The company, disregarding the market conditions, is henceforth required to post firm quotes on regular and ongoing basis – they are basically required to act as market makers: which had caused lots of algorithmic traders’ anxiety.

The first level of the Directive also defines the rules that the member-states are bound to abide, in order to provide a healthy and specifically:

“Member States shall require a regulated market to have in place effective systems, procedures and arrangements to ensure its trading systems are resilient, have sufficient capacity to deal with peak order and message volumes, are able to ensure orderly trading under conditions of severe market stress, are fully tested to ensure such conditions are met and are subject to effective business continuity arrangements to ensure continuity of its services if there is any failure of its trading systems.”

The trading venues will also be affected by the new regulation, being required to put up with stricter requirements. They are bound to provide the “*co-location of the venue’s matching engine [...] on a non-discriminatory, fair and transparent basis*”³⁵. Such instruments as *speed bumps* will be put in place, whose roles would to slow down, artificially, trade order speed once it will have considered excessive, *order-to-trade ratios*³⁶ - with the purpose of preventing frequent and fast order submission/cancel, Market participants that will place and subsequently cancel the order, repeatedly, will be subject to higher fees imposed by the trading venue. And last but not least, *risk control systems* – which will secure the resilience of trading venues.

ESMA was burdened with regularly providing effective strategies to tame the out-of-control algorithmic trading, by constantly consulting the fields experts. Its purpose will be to

³⁵ MiFID II – Recital 62

It is stated that the market participants’ facilities are always choosing to be positioned physically close to the to a trading venue’s matching engine, due to the fact that this proximity facilitates HFT.

³⁶ MiFID II – Recital 68

keep the pace with technological developments in financial markets and maintain market integrity³⁷.

6. Sanctioning regime

The new directive and regulation have pressed matters also in the field of regulation's breaches. It has focused more on strengthening and guaranteeing a more harmonized system of administrative sanctioning. *"The use of criminal sanctions is framed so as to ensure the cooperation between authorities and the transparency of sanctions."* (European Commission Press Release, 2014)

The sanctioning regime is defined under Article 51 MiFID I – which states:

"[...] Member States shall ensure, in conformity with their national law, that the appropriate administrative measures can be taken or administrative sanctions be imposed against the persons responsible where the provisions adopted in the implementation of this Directive have not been complied with. Member States shall ensure that these measures are effective, proportionate and dissuasive."

MiFID – Article 51 (1)

However, MiFID II places a more important focus upon the compliance policy, thus specifying that:

"In order to ensure compliance by investment firms, market operators authorised to operate an MTF or OTF, regulated markets, APAs, CTPs or approved reporting mechanisms (ARMs), those who effectively control their business and the members of the investment firms and regulated markets' management body with the obligations deriving from this Directive and from Regulation (EU) No 600/2014 and to ensure that they are subject to similar treatment across the Union, Member States should be required to provide for sanctions and measures which are effective, proportionate and dissuasive. Administrative sanctions and measures set out by Member States should satisfy certain essential requirements in relation to addressees, criteria to be taken into account when applying a sanction or measure, publication, key powers to impose sanctions and levels of administrative fines."

³⁷ MiFID II – Recital 68

Furthermore, the new Directive denoted that the sanctions' amount should be high enough to have a dissuasive effect upon the institutions and their managers – act a proof that is might be more beneficial to abide the terms, rather than breaching them.³⁸ The publishing of sanctions and authorities' decisions regarding the previous infringements is believed to only strengthen the discouraging effect, thus is highly recommended.³⁹

In order to enforce such compliance, the competent authorities shall have, under the national law, constant access to all the all the relevant information on the legal person's activity⁴⁰. Should any suspicions about market abuse arise, the authorities will be able to verify all the data (recordings of telephone conversations and data traffic records from executing firms, and telecommunications operators), and act should enough evidence be detected.

7. Investor protection

The seventh and, as far, most important change within the new Directive had represented the *Investor protection*. The first directive had played an important role in the ensuring the proper level of protection for investors all across the EU, but some areas were still not covered, and others provisions were badly being implemented.

The second directive has brought a wide number of changes to the investor protection regime. These changes are bound to influence and the full lifecycle of investment products.

These changes can be narrowed down to:

1. Increased *transparency*, allowing customers to have a better understanding where costs, fees, charges are concerned.
2. Defining the *advising service* - that is tailoring the strategy proposed to the client to clients' needs.

³⁸ MiFID II – Recital 142

³⁹ MiFID II – Recital 146

⁴⁰ MiFID II – Recital 143

3. Managing the revenue impact that the two previous changes would have on the *inducements free offerings*.
4. Imposing stricter rules regarding *product distribution* and *control*.
5. Redefined *administrative responsibilities* for investment companies.

Investor protection represents a key element within both MiFID I and MiFID II. The topic, the main issues and changes will be discussed in the chapter bellow.

Chapter 3 Investor Protection.

3.1 MiFID I provisions

The European Union attaches great importance to investor protection and defending investor's rights. In most European Member states, the investment legislation was well developed, but there was a need to consolidate and harmonize. The first Directive – MiFID has to be considered *“a milestone for investor protection since it pursues the progressive approach by the EC of systemic protection, when compared to the approaches adopted in the previous three directives that pursued fair distribution of investment information to investors. Consequently, the MiFID in accordance with the best interests toward the integrated European securities without a centralized EU securities regulator.”* (Lee, 2009)

Many researchers had found that the provisions of MiFID I to enforce a safe investment environment and a high level of investors' protection of have been at least questionable, if not inefficient. In his research John J. A. Burke, in 2009, after examining MiFID's investor protection provisions and articles in the *“larger context of the macroeconomic function of financial markets, and the theoretical underpinnings of investor protection in the United States and in Europe, as well as the practical track record of enforcement of investor protections in Europe to evaluate the effectiveness of investor protection under the new instruments.”* has reached the conclusion that *“the style of investor protection envisaged within MFID is likely to impose substantial costs upon investors to the benefit of investment firms, while probably falling short of fulfilling the promises of the risk/reward equation. The effectiveness of investor protection, which depends exclusively upon the quality of enforcement, is questionable given the European Union's passive enforcement style toward financial market misconduct”* (Burke, 2009)

Moreover, MiFID's provisions had proved to be difficult enough that there was a reasonable risk that companies will not be able to withstand such pressure. Financial Services Authority in its press release had recognized that a difficult economic situation can shift

“investors interests” from investment company’s priorities, denoting that *“There is a risk that due to the increased financial pressures on firms, they may not make the same endeavors to comply with conduct-of-business requirements, such as treating customers fairly and quality of advice. Where firms are faced with financial difficulties, there could be a tendency to concentrate on immediate problems.”* (FSA, 2008 p. 25)

One of the objectives of MiFID was to increase investor protection, to harmonize and adapt all operations across Europe to potential investors’ level of their knowledge and experience in the investment field. To do so, the Directive requires investment services providers to assess more thoroughly the suitability of services for their customers.

The directive specifies all the necessary prerequisites for all the financial intermediaries, that the latter have to abide, and keeps all the information and answers to which could be made references whenever investment process questions might arise.

Frankly speaking, MiFID sets three main principles that the professional participants of the securities market must comply with:

- act honestly, fairly and professionally in accordance with client’s best interests.
- provide clients with an appropriate and complete information that is specific, clear and indubitable.
- provide investment services that take into account client’s specific situation.

MiFID I’s has written the whole 2 defining the *“Provisions to ensure investor protection”*, where starting with Article 19 it defines the rules of conduct for the investment companies. The latter are bound to ensure that the companies act *“honestly, fairly and professionally in accordance with the best interests of its clients”* when providing financial services. Moreover all the information that the company would provide to the client must be *“be fair, clear and not misleading.”*⁴¹, containing details about the investment firm, such as:

“— the investment firm and its services,

⁴¹ MiFID – Article 19 (2)

— *financial instruments and proposed investment strategies; this should include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies,*

— *execution venues, and — costs and associated charges”*

Being provided with this information the clients would be able to “*understand the nature and risks of the investment service [or] financial instrument [...] and consequently, to take investment decisions on an informed basis.*”

Article 19 defines also the rules that the companies would have to abide when advising their clients about the investment strategies the latter could pursue, stating that:

“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.”

Moreover, the Member States would have to make sure that such companies⁴² would taking into account client’s level of “*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.*”. Should the company consider the product at hand as unsuitable for the client – it would advise the client against it, or inform about the risks that the client might undertake by proceeding with the chosen strategy/product. In the case that the client refuses to provide the needed information for assessing it’s level of knowledge, the company should, thus, inform him that is unable to determine “*whether the service or product envisaged is appropriate for him*” and he might be subjected to a high level of risk.

Nonetheless, should the company provide only such services as “*execution and/or the reception and transmission of client orders*”, they might be permitted to not ask the

⁴² All the companies except those specified in paragraph 4 of MiFID I.

aforementioned information from the client, although this is true only under following conditions:

- *“shares [are] admitted to trading on a regulated market or in an equivalent third country market, money market instruments, bonds or other forms of securitized debt (excluding those bonds or securitized 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,*
- *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 standardized format,*
- *the investment firm complies with its obligations under Article 18⁴³.”*

The investment company is bound, under Art. 19, to also provide the client with a report about the services provided to its clients, and the reports is advised to contain (where applicable) all the information containing *“costs associated with the transactions and services undertaken on behalf of the client.”*

In the case that the client has issued the order through an intermediary, the investment company is advised to follow the instructions transmitted by the intermediary (which has to take responsibility for the accuracy of the order instructions), the company only being responsible for executing the order.⁴⁴

⁴³ Article 18 of MiFID I specifies all the provision related to the “Conflicts of interest” issue.

⁴⁴ MiFID – Article 20 (1)

Another issued ties close to the *investor protection* topic, is the *best execution*. The provisions related to best execution are described under the Article 21 that is “*Obligation to execute orders on terms most favorable to the client*”. It obliges the companies, under direct requirements from Member States to guarantee that the companies are following the best and most favorable strategy when executing client’s order. To ensure that the company must take into account the “*price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.*” (provided that it did not receive specific instructions related to such details directly from the client).⁴⁵

Following the execution, the company must provide all the info related to orders’ execution, retaining all the information about where, at what time, etc. thus presenting the client with the opportunity to “*monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies*”.

Article 22 denotes the rules that the investment company has to comply with when executing clients’ orders. Should the client’s order be not executable – the investment firms are, should they lack strict instructions from the client itself, given the possibility to act of its own behalf, but always in client’s best interest⁴⁶.

Client Segmentation

To protect investors, the directive obliges customers to be divided into categories when providing investment services. Investor will be the one to win from the adoption of MiFID, with all the investment companies being forced to compete with one another. Investors’ profitability has increased also, the competition has lowered the costs for the issuers and investors, also giving the investors a broader choice of products to invest in.

⁴⁵ MiFID – Article 21 (1) – (2)

⁴⁶ MiFID – Article 22 (1) – (2)

According to the MiFID requirements, companies must classify customers according to three main categories:

- *professional client*⁴⁷
- *eligible counterparty*⁴⁸ and
- *retail clients*⁴⁹

in order to assess their “compliance” with the suggested products, as defined by Rec. 31 of MiFID:

“One of the objectives of this Directive is to protect investors. Measures to protect investors should be adapted to the particularities of each category of investors (retail, professional and counterparties)”

MiFID – Recital 31

The purpose of this division is to provide appropriate services based on just how big the customer’s experience in the securities market is, to choose the most appropriate type of service for the client, and to apply different levels of protection based on their segmentation.

⁴⁷ *“Professional client is a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs. In order to be considered a professional client, the client must comply with the following criteria”* MiFID – Annex II

Annex II of MiFID specifies which of the clients should be specifically considered as professionals. As specified above, there’s a list of criteria that the latter must comply with to be considered as such, specifically they must be:

“(a) Credit institutions (b) Investment firms (c) Other authorized or regulated financial institutions (d) Insurance companies

(e) Collective investment schemes and management companies of such schemes (f) Pension funds and management companies of such funds (g) Commodity and commodity derivatives dealers (h) Locals (i) Other institutional investors”

They also have to comply with two of the following requirements: *“balance sheet total - EUR 20 000 000, net turnover - EUR 40 000 000, own funds - EUR 2 000 000.”*

⁴⁸ *“Member States shall recognize as eligible counterparties [...] investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, other financial institutions authorized or regulated under Community legislation or the national law of a Member State, undertakings exempted from the application of this Directive under Article 2(1)(k) and (l), national governments and their corresponding offices including public bodies that deal with public debt, central banks and supranational organizations.”* MiFID – Article 24 (1)

⁴⁹ *“Retail client - means a client who is not a professional client;”* MiFID II Article 4 (1) 11

The highest level of protection for customers refers to the *retail customers* - this means that the client receives in this category a wide range of relevant information on investment products and services and, at the same time, will be advised of the potential risks associated with pursuing of investment strategies of his choice. Most will be classified as “*normal customers*”, which includes individuals.

It is assumed that these customers are able to make their own investment decisions and correctly assess the potential risks, therefore they do not require such a high degree of protection, as opposed to retail customers.

Clients can be transferred, in accordance with the terms of the legislation, into another category. Transfer from ordinary customers can mean the loss of the right to compensation on the part of the system of external guarantee (which is similar in purpose to the Reserve Fund of professional securities market participants) and the means to restrict or eliminate certain obligations to the Reserve Fund of professional securities market participants in relation to ordinary customers.

Customer Profiling

Although much and more is said about customer categorization, customer profiling is not as covered in literature as it would be expected. MiFID made it become an obligation.

This client profiling reminds more of a “*skilled – unskilled*” division, but is a necessary step for protecting the persons who are not knowledgeable enough, don’t really possess the necessary skills to trade in financial instruments and are not able to fully understand and assess the risks related to their product of choice (consequently, there is a high probability their expectations will not be satisfied).

Today’s the investment decisions, to large extent, influence life in the future - that is, from today's choice of a pension plan depends on the amount of maintenance in the future pension period. Therefore, the client must carefully and independently analyze the risks

associated with investment activities and to take into account their possible impact and consequences. It should also take into account the properties of each particular security, services or other investment product, possible profitability, according to his level of risk tolerance and investment objectives.

In particular, MiFID I requires investment firms to offer clients (investors), of certain financial products and services, to determine their investment profile on the basis of two tests:

- Suitability test -The duty to do the suitability test arises whenever the firms has to provide investment services, or when to act as an investment advisor. I this way the investment firm shall obtain the necessary information on the knowledge, experience, client's financial position and investment objectives in order to be able to recommend those investment services and financial products that are suited to the client, its status, expectations and needs.

The test for suitability is not necessarily only a requirement related to retail investors but also professional clients and eligible counterparties.

However, for professional clients, the investment firms—assuming that the later possess the required level of knowledge and experience—assesses only their financial situation and investment objectives.

- Appropriateness test – The test, compared to the suitability one, is carried out on all other cases of furnishing the investment services, (in particular, the performing orders received from brokers). They conduct this test in order to assess the appropriateness of a product or service for a particular client. Therefore, the company must request from the client information about his knowledge and experience.

Just as in the case of the suitability test concerning “professional clients” investment firms are allowed not to dismiss additional checks that the clients possess the necessary knowledge and experience.

3.2 MiFID II provisions

The Directive second edition (MiFID II) expands even more ways to protect the client, establishing additional powers for the states support of transparency in the markets and “fencing” off investors of knowingly unprofitable products. FSA’s statement that “*market participants and consumers may lose confidence in financial institutions and in the authorities’ ability to safeguard the financial system*” (FSA, 2008. p. 28) remains the undoubted truth, thus state regulators seek to create an investment climate in which every investor, whether he invests millions of euro inheritance or a few thousand euros of pension accumulations, could feel protected from the market arbitrariness.

Though MiFID I’s provisions were detailed enough, the crisis of 2008 has exposed the regime’s weaknesses. The Commission, in 2010 has issued a paper, related to the needed changes in the first Directive, and, the following year has followed up with specific proposals. The Commission has stated that the investors protection regime had needed to be updated in the face of complex financial instruments and perpetual innovation.

“In recent years more investors have become active in the financial markets and are offered an even more complex wide-ranging set of services and instruments. In view of those developments the legal framework of the Union should encompass the full range of investor-oriented activities. To that end, it is necessary to provide for the degree of harmonization needed to offer investors a high level of protection and to allow investment firms to provide services throughout the Union, being an internal market, on the basis of home country supervision”

The provision for harmonizing the Investor protection had been denoted in the Section 2 of the Delegated act. Its opportune to mention that the Second Directive had the focus upon not changing the existent provision, but only strengthening them – presenting a series of changes in the most important areas concerning the *Investors Safety*, which can be summarized as follows:

1. Inducements:

Inducements⁵⁰ were also stipulated within MiFID I, but MiFID II has brought significant changes to the topic. Under the new Directive the companies will be able to accept some inducements, but under some firm restrictions. Recital 74 delegates that:

“In order to strengthen the protection of investors and increase clarity to clients as to the service they receive, it is also appropriate to further restrict the possibility for firms providing the service of investment advice on an independent basis and the service of portfolio management to accept and retain fees, commissions or any monetary and non-monetary benefits from third parties, and particularly from issuers or product providers. This implies that all fees, commissions and any monetary benefits paid or provided by a third party must be returned in full to the client as soon as possible after receipt of those payments by the firm and the firm should not be allowed to offset any third-party payments from the fees due by the client to the firm.”

“Only minor non-monetary benefits should be allowed, provided that they are clearly disclosed to the client, that they are capable of enhancing the quality of the service provided and that they could not be judged to impair the ability of investment firms to act in the best

Following, the 75th Recital of MiFID II states that such benefits are allowed only in the case when the investment advice is provided on the independent basis, the client is fully aware of any payments that have been made on his behalf, and the amounts have been previously discussed with the client. This type of inducements is also called as “*third party payments*”, and for retail clients they represent a research fee. Their purpose is to enhance the quality of the service provided to the client. ESMA’s opinion upon the issue that such minor, non-monetary benefits are safe to be disclosed to the public, although in a very generic way. Nonetheless, “*MiFID II will introduce a complete ban on some firms receiving a payment or some other form of non-monetary benefit from third parties (such as payments that managers of investment funds make to investment the future, any portfolio manager or firm which says they provide [the investor] with independent financial advice will no longer be able to accept or retain payments (fees, commissions or any other monetary benefit) or*

⁵⁰ Inducements are referred to as “any monies, goods or services (other than the normal commissions and fees for the service) offered or received by an investment firm or any of its members of its relevant persons in relation to business for a client with or through another person, whether on a prepaid, continuous or retrospective basis” - CESR’s Technical Advice on MiFID I implementation, 2005

non-monetary benefits that they receive from a third party for a service they carry out on [retail investor's] behalf)"⁵¹

	<i>Accept and retain fees and commissions from third parties?</i>	<i>Accept and retain non-minor monetary benefits?</i>	<i>Accept and retain non-minor non-monetary benefits?</i>
<i>Independent advisers</i>	X	X	✓
<i>Discretionary investment managers</i>	X	X	✓
<i>Other investment firms</i>	✓	✓	✓

Table 3.1 Summary table of position on inducements under MiFID II
Source: : Taylor Wessing Press Release, 2015

2. New “Best Execution” Standards

Acting under the Current regime (MiFID I) the firms are bound to take all the “reasonable steps to obtain, when executing orders, the best possible result”⁵². MiFID II though stipulates that “investment firms [will be required to] take all sufficient steps to obtain, when executing orders, the best possible result for their clients”⁵³. ESMA defines that “the requirement for “sufficient” steps sets a higher bar for compliance than “reasonable” steps.”⁵⁴ Firms will also be required to pay attention to series of factors when executing client’s order such as: “price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order”.

⁵¹ “Enhanced protection for retail investors: MiFID II and MiFIR” ESMA, June 2014

⁵² MiFID I – Article 21 (1)

⁵³ MiFID II – Article 27 (1)

⁵⁴ “Questions and Answers On MiFID II and MiFIR investor protection topics” – ESMA., 16th of December, 2016

However small the wording change might be, the focus that ESMA has put upon this issue shows that the regulator will be expecting that the companies would change their policies, acting in a stricter way to ensure the reach of best execution.

ESMA has issued a technical standard, adding the fairness test when deciding the possibility of the best execution, taking into account the price, when trading on the OTC market, stipulating “*MiFID II strengthens the existing best execution standard in relation to OTC products. In this regard, Article 64 of the MiFID II Delegated Regulation requires firms to check the fairness of the price proposed to the client when executing orders or taking decisions to deal in OTC products, including bespoke products, by gathering market data used in the estimation of the price of such products and, where possible, by comparing with similar or comparable products*” (ESMA, 2016 p. 12), although stipulating that these requirement is not necessary to be followed for every single client order.

3. *Independent advice*

Investment service companies must inform their clients whether the advice is provided upon:

1. Independent analysis, or
2. Broad/restricted analysis of the market.

Recital 73 stipulates:

*“When advice is provided on an **independent basis** a sufficient range of different product providers’ products should be assessed prior to making a personal recommendation. It is not necessary for the advisor to assess investment products available on the market by all product providers or issuers, but the range of financial instruments should not be limited to financial instruments issued or provided by entities with close links with the investment firm or with other legal or economic relationships, such as a contractual relationship, that are so close as to put at risk the independent basis of the advice provided.”*

MiFID II – Recital 73

This stipulation is expected to provide a healthy investments environment, as well as ensure a presence of choice as for the clients, as well as for the companies.

4. *Enhanced information to clients*

MiFID II places a great focus upon the issue of giving the clients all the detailed information about investment products. For the companies advertising their services, bundled up with products – they must inform their clients whether these can be bought separately, and also provide all the details regarding the charges for all of the components.

Article 24 denotes:

“Appropriate information shall be provided in good time to clients or potential clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges. [...]:

c) the information on all costs and associated charges must include information relating to both investment and ancillary services, including the cost of advice, where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, also encompassing any third-party payments.

.”

MiFID II – Article 24 1 (c)

Companies are required to provide all this information each year, during the “life” period of the investments. Companies should also inform their clients whether they will perform a suitability assessment of their products of choice.

5. *Suitability and appropriateness*

Probably one of the most important issues regarding *investor protection* being addressed by MiFID II. These provisions were also covered under the first Directive, though with some loopholes. The provisions, and their adequate functioning are to be strengthened by the

second Directive. Article 25th of MiFID II “*Assessment of suitability and appropriateness and reporting to client*” addresses this issue, stating that:

“Member States shall require investment firms to ensure [...] that natural persons giving investment advice or information about financial instruments, investment services or ancillary services to clients on behalf of the investment firm possess the necessary knowledge and competence to fulfil their obligations [...]. Member States shall publish the criteria to be used for assessing such knowledge and competence.”

Investment companies are thus bound to assess the competences of their clients, when counseling the client regarding their strategies of choice. They are bound to “*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, that person’s financial situation including his ability to bear losses, and his investment objectives including his risk tolerance*”⁵⁵ before providing their advice regarding the package of bundled products and services. The information to be obtained is denoted in the table below:

<p>The knowledge and experience of the client</p>	<ul style="list-style-type: none"> - the types of service, transaction and the regulated investments with which the client is familiar; - the nature, volume, frequency of the client’s transactions with regulated investments; and - the level of education, profession or relevant former profession of the client.
<p>The client’s financial situation</p>	<ul style="list-style-type: none"> - the source and extent of the client’s regular income; - the client’s assets, including liquid assets, investments and real property; and - the client’s regular financial commitments. - <u>ability to bear losses</u>

⁵⁵ MiFID II – Article 25 (2)

The client's investment objectives	<ul style="list-style-type: none"> - the client's investment horizon; - the client's risk preferences, risk profile and <u>risk tolerance</u>; and - the purposes of the investment
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Table 3.2 Information to be obtained for the suitability test
Source: : Nagelkerke, 2016⁵⁶

The main focus here is put upon the level of client's risk aversion and his ability to bear losses.

Thus the *suitability test* must be done by the companies that provide investment advice (disregarding the fact that its independent or not), and by the portfolio manager acting on the behalf of the client. The firm should obtain all the information prior to providing the advice. Should the investment company fail to provide the suitability opinion prior to the transaction itself, it still has the possibility to provide it in a written manner immediately after the conclusion of the transaction, but only under 2 conditions: "*the client has consented to receiving the suitability statement without undue delay after the conclusion of the transaction; and (b) the investment firm has given the client the option of delaying the transaction in order to receive the statement on suitability in advance.*"⁵⁷

Moreover, Article 25 bounds the investment companies to also provide written periodical communications (*suitability reports*) regarding:

- the outline of the given investment advice;
- the explanation of how the investment advice meets client's risk aversion and financial strategy;

For performing the *appropriateness test* the companies must assess their client's experience within the investment field, and their knowledge. According to same Art. 25 point 6, firms are obliged to perform the assessment of the financial instrument which the client is

⁵⁶ "*MiFID II Academy - Suitability and appropriateness*" by Floortje Nagelkerke, Norton Rose Fulbright Article, 9th of February 2016

⁵⁷ MiFID II – Article 25 (6) a/b

set to *buy, sell or hold*. Should the package of choice be unsuitable⁵⁸ for the client, the client must therefore warn the client of its inappropriateness and riskiness. These rules apply to all companies that execute client’s orders, send/receive orders or trade on their own account.

The types of information the firms must obtain in order to perform the appropriateness test are specified in the table below:

The nature of:	<ul style="list-style-type: none"> - financial service, - transaction and - regulated financial instruments the client is familiar with
The volume/frequency of:	<ul style="list-style-type: none"> - of the client’s transactions in regulated financial instruments;
The level of:	<ul style="list-style-type: none"> - education, - profession or - former profession of the client

Table 3.3: Information to be obtained for the appropriateness test
Source: : Nagelkerke, 2016⁵⁹

The appropriateness test might not be performed when the products are deemed to be “non-complex”⁶⁰, the clients were, prior to providing the investment service, that the

⁵⁸ Company’s opinion will be formed on the basis of the information provided by the client, and the suitability/appropriateness assessment performed by the investment firm’s manager.

⁵⁹ “*MiFID II Academy - Suitability and appropriateness*” by Floortje Nagelkerke, Norton Rose Fulbright Article, 9th of February 2016

⁶⁰ *Non complex* products are referred to the following instruments:
“(i) shares admitted to trading on a regulated market or on an equivalent third-country market or on a MTF, where those are shares in companies, and excluding shares in non-UCITS collective investment undertakings and shares that embed a derivative;
(ii) bonds or other forms of securitized debt admitted to trading on a regulated market or on an equivalent third country market or on a MTF, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved;
(iii) money-market instruments, excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved;
(iv) shares or units in UCITS, excluding structured UCITS as referred to in the second subparagraph of Article 36(1) of Regulation (EU) No 583/2010;
(v) structured deposits, excluding those that incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term;
(vi) other non-complex financial instruments for the purpose of this paragraph.” - MiFID II – Article 25 (4) a

company does not perform the suitability assessment of the service/financial product offered, or in the case no “*credit limits of loans, current accounts and overdraft facilities of clients*”⁶¹ were involved. In these cases, the client does not have the advantage of the suitability rules protection.

ESMA was charged with providing the guidelines for the suitability and appropriateness assessment, not only the criteria of denoting the client’s level of knowledge and competence⁶², but also for all the financial instruments or deposits “*incorporating a structure which makes it difficult for the client to understand the risk involve*”⁶³. On 7 December 2015 ESMA publishes the “Final Report on MiFID II Guidelines on Assessment and Knowledge of Competence”, that will come into effect on 3 January 2017.⁶⁴

The difference between the two definitions (*suitability* and *appropriateness*) might seem subtle, but the two refer to different issues. Suitability is referred to the management and consulting field, meanwhile the appropriateness refers to the investing services. The distinction is the depth of clients’ analysis, because meanwhile the first is made only on the basis of the knowledge and experience, the second is made based on the portfolio, level or risk aversion etc.

Amid the global financial crisis, the increased volatility in the financial markets when the fluctuation of prices of real assets reaches its extremes, a noticeable shift of markets toward disclosure and greater protection of the investors’ rights was noticeable. This is, in biggest part, due to the state regulators activity in developing the right management strategy to improve the relationships between the banks and their customers.

MiFID Directive tackled *risk tolerance assessment*, presenting it as one of the main point. Under the specific requirement, the banks and other financial intermediaries were bound to assess their clients’ risk preferences prior to providing investment services or selling

⁶¹ MiFID II – Article 25 (4)

⁶² MiFID II – Article 25 (9)

⁶³ MiFID II – Article 25 (10) a-b

⁶⁴ Source: ESMA’s press release, 17th of December 2015. Source: <https://www.esma.europa.eu/press-news/esma-news/esma-publishes-final-report-mifid-ii-guidelines-assessment-and-knowledge>

investment products. This regulation was set out explicitly for eliminating the *information asymmetry* present within the financial institutions vs. client rapport, allowing them *to get to know their customers*. The information asymmetry is an indisputable part of the bank-client rapport, as it becomes effectively impossible for all the future investors to have access to all the information, and be able to correctly process it for taking a prudent decision regarding its investment strategy. Because of the investor's *bounded rationality*⁶⁵, arises the necessity to recur to financial and investment advising. The bank's manager will hence analyze the client from many perspectives in order to formulate an investment strategy best fitting client's necessities, adequately tied to his risk tolerance and financial situation.

The information needed for this assessment is required to be provided by the client, by way of compiling a standardized questionnaire with a certain types of questions.

This is a mandatory step for clients as well as for the bank, and it is equally important for both, although more for the client, and should not be taken lightly. The client's responses would serve to create a fitting strategy, and if they were to be not accurate, it would result into a non-appropriate strategy with unwanted consequences for the client's portfolio.

As stipulated before, MiFID I's Article 19 defines the information needed for an appropriate assessment.

„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”

MiFID I - Article 19

⁶⁵ A theory developed by Herbert Simon, an American economist, according to which the people will choose not the most optimal decision in a situation, but a *sufficiently acceptable one*. According to the author people are not seeking to maximize their benefit, due to the fact that they are not able to assimilate and process all the necessary information to do so.

Although the Implementing Directive⁶⁶ goes further providing explanations and defining terms, there is still a large loophole upon how to interpret the requirements. Especially difficult is to understand the tools used to calculate and define client's risk profile. Although the directive is quite accurate and detailed where client's experience and knowledge level is concerned, it lacks the description upon how to establish client's risk aversion and other aspects of investors' risk profiles.

Implementing Directive Article 36 (1) defines the purpose of obtaining the information:

„Member States shall ensure that the information regarding a client's or potential client's knowledge and experience in the investment field includes the following, to the extent appropriate to the nature of the client, the nature and extent of the service to be provided and the type of product or transaction envisaged, including their complexity and the risks involved:

a) the types of service, transaction and financial instrument with which the client is familiar;

b) the nature, volume, and frequency of the client's transactions in financial instruments and the period over which they have been carried out;

c) the level of education, and profession or relevant former profession of the client or potential client

Implementing Directive - Article 36 (1)

The key requirement is that the client is truly familiar to the products he claim to be familiar. For instance, should the client claim to be no stranger to exotic derivatives, it will not necessary mean that the manager should suggest he invests in such. It is vital for the client to understand that it is in his best interest to disclose the truthful information regarding his knowledge and experience, and it is upon the adviser to explain such details. Furthermore,

⁶⁶ The Implementing Directive defining the MiFID I (Directive 2004/39/EC) purposes more specifically, especially regarding the operating requirements and organizational conditions for investment firms.

this suitability assessment is vital for not only increasing customer trust in financial markets, but also providing stability to the financial statement.

Upon using the assessment, the bank will deem the client as *qualified*. This status will be given judging on the client's sufficient experience in transactions with securities in the stock market, his level of knowledge in the field of financial markets and also the available capital for investment. The meaning of the qualified term is that the such an investor needs less protection in the securities market, because it is believed that he is more aware of the occurring risks. Accordingly, it offers the bank the possibility to offer the client the riskier financial instruments, compared to a non-qualified client. In addition, it is common knowledge that assisting a qualified investor turns out cheaper for the bank.

Commonly, all the required information about client's qualification is gathered using a pre-determined questionnaire, whose purpose is to disclose client's knowledge, familiarity with products, preferences, possible investment choices etc. The questionnaire functions as a "*get to know your customer*" instrument, eliminating the eventual ill advisement and misunderstanding.

MiFID, although requiring the banks to analyze the clients, it gives only vague indications about how to do it. The banks are thus required to interpret the normative, and then transpose them into questionnaires, thus each financial service provider is in right to, personally, draft its questionnaire. The only request is that the questionnaire must be rigorous enough, to cover all the areas of the client's needs, as to be able to profile it later.

The main purpose on client's profiling is to, subsequently, determine the *suitability* and *appropriateness* of a financial instrument for the client at hand.

Marinelli and Mazzoli (2011) define the difference between the two concept questionnaires, as shown below:

	Suitability	Appropriateness
<i>Application field</i>	<ul style="list-style-type: none"> • Portfolio management • Investment advice 	Investment services other than portfolio management and investment advice. No test is required for execution only service.
<i>Set of information</i>	Three sections: <ul style="list-style-type: none"> • investment objectives; • financial capacity; • experience and knowledge. 	One section: Experience and knowledge.
<i>Type of financial intermediary</i>	Compulsory questionnaire: if the questionnaire is not filled up by the client, portfolio management and investment advice services cannot be provided.	Non-compulsory questionnaire: if the client refuses to give some information, the service may be provided all the same, but under a disclosure obligation by the firm.

Table 3.4 Suitability questionnaire and Appropriateness questionnaire: a comparison
Source: Marinelli and Mazzoli (2011)⁶⁷

As a result, the questionnaires differ from one financial intermediary to other. A more in-depth analysis of the different questionnaires will be provided in Chapter 5.

As a tool, the questionnaires seem to also have a range of limitations. The same person might be profiled differently after filling-in different questionnaires. In fact, it remains increasingly difficult to profile a person regarding the level of his risk aversion or risk seeking based on a range of descriptive questions. The results are quite subjective and, as of late, the

⁶⁷ “Profiling investors with the MiFID: current practice and future prospects” by Camilla Mazzoli and Nicoletta Marinelli (2011)

true level of a client's risk tolerance and its bad-matching with his risk profile assigned by the bank, has risen in the visor of the European regulators. Not only that ESMA published a series of guidelines regarding the correct examination and identification of the client's level of risk tolerance, but also Autorité des marchés financiers (AMF), a French financial markets authority along with its British colleagues - the Financial Services Authority (FSA) have issued studies and procedures regarding this issue.

In fact, retrieving such information and building a good investment strategy becomes a struggle, which might result in erroneous conclusion and decisions. This is solely due to the fact that client's risk preferences are in fact influenced by a large number of factors, as will be explained more in-depth below.

Chapter 4 Client's financial risk tolerance

The term “risk” in the financial sector is used in a variety of contexts. In general, the risk represents the need to make a choice in contexts where it is impossible to determine the results in advance. The result of such choices can be either profit or loss, or the absence of change. The financial press often uses the term "*risk tolerance*" with regard to investor feelings. The last though may subsequently change being affected by some particular events. However, modern economic theory of the investment portfolios and strict requirements for the optimal investments allocation are based on expected utility analysis and the concept of risk aversion (reverse risk tolerance). The economic literature and the literature devoted to personal finance management traditionally pays a lot of attention to the concept of "*risk aversion*".

For people working in the conditions of modern economy, risk aversion is the key when choosing among a variety of financial strategies. Stigler and Becker (1977, p. 76) noted that people's preferences (tastes) "... *do not change in a whim, and, moreover, do not have strong individual differences*"⁶⁸. The researchers believe it is possible that individual preferences are due to genetic differences between individuals or the characteristics of their early socialization. The data suggested that on level of investors risk tolerance have influenced their past achievements and failures, financial and life goals, the ability to handle stress, the degree of self-confidence, the desire to control their life situation, and even some of the features of its genetics and neurophysiology. Lindamood and Hanna relate that there are at least four methods of retrieving information about client's risk tolerance, that is: asking directly about client's investments decision, the combination of his investment, asking subjective questions all the while assessing his actual behavior, or asking to make a decisions

⁶⁸ According to the two scholars, people's preferences, once formed, will usually remain unchanged, being subject to change only under a heavy advertising. Often producer of goods would actually manage to persuade the customer to prefer his products to those of his competitors. Heavy advertising is different from simple advertising, the difference consisting its purpose. While simple informative advertising focuses on just informing potential customers of a new product, heavy persuasive advertising's purpose is of forcefully persuading them to buy new product.

on the basis of hypothetical scenarios (2004, p. 29). Of course, we must not disregard the objective market characteristics – the processes creating uncertainty on the market, which may give rise to potential risks for the participants. For instance, the volatility of investors' income, the correlation between the incomes earned by an investor and equity returns etc. The complex issue of risk tolerance has led to a distinction between risk attitudes (preferences) of an individual and his ability to bear the risk – that is risk capacity. Assuming that true risk tolerance does not change from one demographic group to another, the key to developing a working investment strategy for the client must be based on the risk analysis of the current economic situation. The degree of influence of risk tolerance on the best investment choice depends on the person's ability to take risks. For example, young investors who choose to invest in pension funds are expected to have relatively high level of risk tolerance (the ability to take risks), taking into account the long time that they until retirement. For them it makes no sense (even for those of them who have a low level risk tolerance) to choose conservative portfolios. For people approaching the retirement age, or people who already retired, the problem of tolerance and building an optimal portfolio of investments is much more complex. In such cases, a conservative distribution of personal investments would be much more appropriate.

A few years ago, there was a very significant amount of researches on the problems related to the risk tolerance of various population groups. The emphasis in such researches was often put, though, on the investment behavior of qualified investors. Until lately there was little research which covered the issues related to relationship between individual's financial literacy and his attitude to financial risk. There is a significant lack of techniques for the measurement individual's risk perception and risk tolerance. Kogan and Wallach - built one of the first techniques in 1960^s - The Kogan Wallach Risky Shift Questionnaire. It was the first instrument to propose rudimentary forms of individual' risk attitude. Following them, in the '90^s USA have developed an evaluation system related to the risk within the The Survey of Consumer Finances project conducted by the National Opinion Research Center. However, all of these measuring instruments have their limitations.

In particular, critics point out the fact that the questions asked in the Survey of Consumer Finances (SCF) project framework actually assesses the degree of familiarity of most respondents with financial terms, not their risk tolerance. Another version of risk attitude assessment, proposed as part of the Health and Retirement Study, requires respondents to understand risk as a sort of gambling. In particular, as the researchers note, the basic components of the process recognized as client's risk profiling represents, in fact, a method of assessing risk tolerance, linking it with the characteristics of the investment portfolio.

4.1 Financial literacy's vs Age and Education: Effects on risk tolerance

Without basic knowledge, skills and a corresponding level of financial literacy is impossible to have a correct governance and use of the variety of financial products and services. Financially educated citizens are more active in the financial markets, have a smaller amount of overdue debts to the bank and tend to be more careful when planning their retirement. Financial markets around the world are becoming more and more available for private investors, just as the new financial instruments and products are becoming more common. With so many choices and opportunities for a person, not competent in such matters, is difficult to understand what he needs to pay attention to when using financial instruments, and to determine what options are the best choice personally for him.

Before starting to invest, the investor must determine his personal investment strategy. The strategy will be based exclusively particular investor's features, regarding the risk tolerance level, level of financial knowledge, time which the investor is willing to dedicate to the investment management process and many else. A vital role in the choice of strategy plays the level of financial literacy. Citizens are aware, to a greater extent, of the typical investment instruments such as bank deposits, and to a lesser extent of such instruments as bonds, stock and other securities.

The use of financial instruments involves certain risks. Investment strategies of different types of investors will vary according to his risk appetite:

- *Aggressive investors* tend to invest in short-term investments products, which in fact are riskier.
- *Moderate investor* decides to invest only after a detailed analysis of the market. He prefers to diversify his portfolio, reducing the risk level, making use of medium-term operations;
- *Conservative investor* attaches great importance to reliability. He's motto will be "better safe than sorry" thus being satisfied with a lower yield, provided that is not risking too much. The main purpose of his investment strategy - to preserve what he has.

Scholars perceive the *Financial literacy* is as the ability of an individual to understand the terminology of the financial market, to calculate the profitability of financial investments, to understand the value of money and predict the likelihood that a negative event occurs. Financially educated individual also distinguishes the types and quality of financial instruments, understands the difference between bonds and shares, can assess the impact of interest rates on the financial asset value.

The data shows that many times the choice of an investment strategy is tied to the knowledge a person has about the market. Many scholars have demonstrated there was indeed a strong correlation between the level of financial literacy and risk tolerance. Taking into account the publications of Swedish scholars such as Engelberg and Sjöberg, which in 2009, using the data about Swedish students that pursued courses of studies in Economics and a group of general population not specialized in finance, showed the financially literate people perceived the financial risk in a more positive light, rather the non-literate people (non-students). They formulated the following hypothesis "*...students of finance will show a more pronounced preference than non-students for economic risk-taking, more gambling and speculation, more sensation seeking, and higher emotional intelligence.*" (Engelberg, Sjöberg, 2009, p.38). This comes in line with the hypothesis formulated by Rui Yao who stated, three years later, that a person who lacks the financial experience and knowledge, needed to be an active market participant, would struggle to identify correctly the level of

risk attached to a certain operation. This will result in a much more risk averse behavior, compared to the person that will not lack the knowledge. However, this is not a dogma – people might still deviate from their usual behavior, “*it is reasonable to anticipate that people will deviate from their general pattern of risk taking from time to time.*” (Grable & Rabbani, 2014. p. 180)

Other studies also tie the level of financial literacy to a person’s age. It is denoted that people over 50-60 years will be inclined to be more financially literate compared to other people. Thus the people who have near the retirement age, thus there is a self-education incentive, idea also sustained by A. Lussardi and O. Mitchell (2007) denoting that the empirical results of her work based on the average American citizens a show a positive relation between the financial literacy and planning of their income after retirement. “*Literacy can also be enhanced by the people who have enough resources and utilize these resources to obtain financial information for implying better outcomes from investment decisions.*” (Awais, 2016). Lussardi and Mitchell states that the studies concluded on younger people, up until 2007, do not present significant results. It is due to the fact that is hard to show evidence of a young person investment approach, whether is aggressive or conservative, as not every one of them has a long-term investment strategy put in place for the retirement. Lussardi speculates the strategy might be formulated, as the person will near the retirement age. As of then, the studies more easy to conduct based on the Health and Retirement Study (HRS), the average age of respondents being 50. Instead, the two scholars decided to conduct the study based on Rand American Life Panel (ALP) – a survey for a group of 812 respondent among which were also people younger than 50 years, and because it had a more accurate approach, with more detailed questions. The analysis was based on a set of eight by sophisticated literacy questions regarding different investment topics:

Questions:

1. *Main function of the stock market*
2. *Knowledge of mutual fund.*
3. *Relation between interest rate and bond prices*
4. *What is safer: company stock vs stock mutual fund*

5. *Which is riskier: stocks vs bonds*
6. *Highest return over long period: savings accounts, bonds or stocks*
7. *Highest fluctuations: savings accounts, bonds, stocks*
8. *Risk diversification*

The tables below show the results that in fact were quite predictive:

	<i>Question</i> <i>1</i>	<i>Question</i> <i>2</i>	<i>Question</i> <i>3</i>	<i>Question</i> <i>4</i>	<i>Question</i> <i>5</i>	<i>Question</i> <i>6</i>	<i>Question</i> <i>7</i>	<i>Question</i> <i>8</i>
<i>Age ≤ 50 (N=350)</i>								
<i>Correct</i>	68.0	69.1	32.6	74.9	82.3	67.7	88.6	76.3
<i>Incorrect</i>	23.4	11.7	42.3	4.0	4.3	22.9	3.4	17.7
<i>Don't know</i>	8.6	19.1	25.1	21.1	13.4	9.4	8.0	6.0
<i>Age > 50 (N=462)</i>								
<i>Correct</i>	81.2	74.9	39.8	84.2	81.2	71.9	89.0	84.8
<i>Incorrect</i>	13.4	11.0	40.3	2.8	4.8	18.8	3.9	9.3
<i>Don't know</i>	5.4	14.1	19.9	13.0	14.1	9.3	7.1	5.8

Table 4. 1 Percent Correct by Sophisticated Literacy Question and Age
Source: Lusardi, A., Mitchell, O.S (2007)

As can be seen, such characteristics as age of the investor are strongly correlated with the financial literacy. On average people that are over the age of 50 present a higher level of knowledge. The group of over 50 responded on average 12% more correct compared to the group of under 50 years old. The author implies that this is due to the fact that the people were required to gather information, invest, build a healthy investment strategy, diversify his risk, being responsible for maintaining their personal wealth.

	<i>Question</i> <i>1</i>	<i>Question</i> <i>2</i>	<i>Question</i> <i>3</i>	<i>Question</i> <i>4</i>	<i>Question</i> <i>5</i>	<i>Question</i> <i>6</i>	<i>Question</i> <i>7</i>	<i>Question</i> <i>8</i>
No College Education (N=389)								
<i>Correct</i>	65.0	62.7	25.2	71.2	75.3	58.9	84.1	73.0
<i>Incorrect</i>	23.4	13.6	48.6	3.6	4.1	29.3	4.4	18.3
<i>Don't know</i>	11.6	23.7	25.2	25.2	20.6	11.8	11.6	8.7
College Education (N=423)								
<i>Correct</i>	85.1	81.3	47.1	86.2	84.8	83.2	90.4	88.7
<i>Incorrect</i>	12.5	9.6	39.9	3.6	5.2	11.8	4.4	7.4
<i>Don't know</i>	2.4	9.1	12.9	10.2	9.9	5.0	5.2	3.9

Table 4. 2 Percent Correct by Sophisticated Literacy Question and by presence of College Education
Source: Lusardi, A., Mitchell, O.S (2007)

The study also reveals that the presence of college education is a factor influencing the people's financial literacy. People with a degree understand better the sophisticated financial and risk terms, thus are able to build themselves a healthy investment strategy. Although the author states that a knowing person not necessarily implies people who undertook an economic university career, but also those people who "*were exposed to economics in school and to company-based financial education programs.*" (Lusardi, A., Mitchell, O.S, 2007)

Remains undoubtedly true that the fact of better understanding the financial terms will result in a much profitable investment strategy, and a more aggressive one. Lussardi and Mitchell quote previous studies of such scholars as Kimball and Shumway (2006) Christelis, Jappelli and Padula (2006) and Hilgert and Hogarth (2003), each of these studies denoting that "*financially unsophisticated households tend to avoid the stock market*", being afraid to lose their wealth investing in products characteristics of which do not understand. In fact, if they decide to start investing – they would most probably choose a very conservative strategy, their objective being only to preserve the amount they have, not risking too much.

4.2 Risk perception and Individual's Expected Utility

The Decision Theory – is a research area involving concepts related to logic, mathematics, statistics, economics, management and psychology in order to study how people find most advantageous possible solution to a specific problem. According to it, people will try to make the best decision regarding the issue, as to be able to get possible outcome. This is the core of the Expected Utility Theory (EUT).

Very briefly, the Expected Utility Theory (EUT) requires „*decision maker (DM) to choose between risky or uncertain prospects by comparing their expected utility values, making the choice in favor of most profitable for him.*” (Mongin, 1997)

Since *utility* is a subjective concept for each investor, depending on personal interpretations, it is quite difficult, if not impossible to be compared between different ones. However, using the utility function allows characterizing the particular investor actions, and therefore better understanding the general vector of the decision-making. To analyze the investor's behavior based on its utility function, it is necessary to determine the shape of the latter. It is reasonable to assume that the investor will always prefer more of his wealth rather than less, as a higher wealth level provides additional possibilities, thus with the growth of wealth increases the total amount of utility. However, for different investors wealth unit may have a different utility.

According to the risk aversion level the investor's utility function changes. On its basis, investors' are then categorized into same three different types: *risk averse, risk seeking and risk neutral.*

The first type of investors, *risk averse* - are those who are not prone to risk. His shape if his utility function is concave with U representing the utility level, and w representing the level of wealth.

$$U(w) = \sqrt{w} \quad (1.1)$$

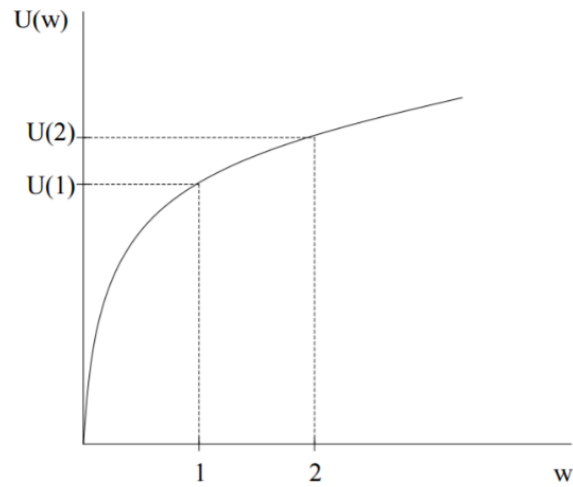


Figure 4. 1 Utility function of a risk-averse investor

This type of investors, choosing between the two assets with the same expected return but different risks, he will choose the less risky asset. Thus the more he risks, the lower the utility personally for him:

The second – the *risk seeking* type of investors is represented by a convex form of utility function.

$$U(w) = w^2 \quad (1.2)$$

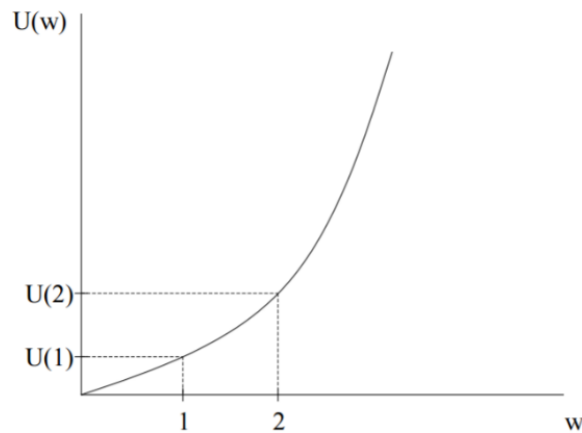


Figure 4. 2 Utility function of a risk-seeking investor

The graph shows that the marginal utility of a risk-seeking investor increases with the growth of his wealth. As a result, among the assets with the same expected return but different risks, the investor will prefer riskier assets.

The third type of investors – *risk neutral* ones – are characterized by a linear function, as can be seen from the figure below.

$$U(w) = w \quad (1.3)$$

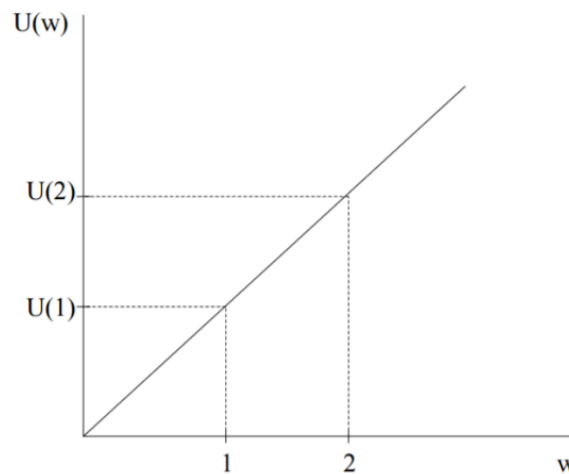


Figure 4. 3 Utility function of a risk-neutral investor

For him the increase in wealth will bring the same change in marginal utility.

The Expected Utility Theory (EUT) was the basic theory to explain the process of decision making for investors, but it is not flawless. Daniel Kahneman and Amos Tversky' back in the '70s have criticized the EU theory, pointing out its limitations. According to the author, people fail to make optimal decisions and perceive the level of risk accordingly, due to a series of factors. People's risk perception might be influenced by:

- *Life period* - youth, maturity, old age. At each stage, the perception of risk and response to it changes.

- *Age*: Young people tend to be reckless; meanwhile old people are very cautious.
- *Gender*: Women tend to be more prudent, than most men.
- *Level of wealth*: poor people are more daring and willing to take more risk. The rich ones, though, are more inclined to preserve rather than take a great risk to gain more.
- *Nationality*: in the mid 70s for a few years a research about the differences between the leaders of different countries was conducted. It was found that the sensitivity of the risk (risk tolerance) leaders from Belgium, Germany and Austria is much lower than the Japanese and Dutch. At the same time, US managers had the highest sensitivity to risk. This result can be interpreted in different ways, but there is no doubt that this difference is significant.
- *Types of risk and level of self-esteem*: Gambling for charity and losing big amounts of money might consider by some it a noble cause, by others – a waste.
- *Cognitive errors* – “*Individuals use heuristics, or rules of thumb, because they have limited attention, memory, education, and processing capabilities.*” (Bikker and de Dreu, 2012, p. 2146)

The new *Prospect Theory* – the alternative developed by the two scholars, advocates a new point of view of decision-making process, which denies the fundamental postulate of the rationality of market participant’s. Kahneman’s research conducted a 70ies of the twentieth century showed that people are not always guided by their own benefit considerations being under the influence of various character traits.

Also, during the financial crisis time, or in times of a financial turmoil, obtaining reliable data is costly, not only in matters of time but also leads to a decrease of investors trust in the received information, and the rise of information asymmetry⁶⁹ issue. The consequence of

⁶⁹ “*The asymmetric information results in adverse selection problem which is the phenomenon where there is a hidden characteristic problem and people on the informed side of the market self-select in a way that is harmful to the uninformed side of the market*” - Tumay M. (2009)

such issue would be a reduction in people's efficiency to process the information. As a result, people's decisions will be subject to subjective factors, such as stereotypes, other's opinion, information received from the media etc. As such their economic decisions will more influenced by psychological characteristics, rather than the need to define the objective characteristics of the portfolio, such as the level of risk, the rate of return, resulting in decisions that are not optimal in accordance with the expected utility theory.

As so, making the process of making the optimal decision will be disrupted by the factor of people's behavior. It should be recalled that the process of making any decisions under uncertainty is based on people's perceiving of two interrelated aspects: objective factors - changes in the external environment, and the subjective factor - how people understand these changes.

Both the objective and subjective factors are vital for forming a good understanding of the issue and the optimal choice to make. The objective factors form the investor's experience, but is the subjective factors that will, at the end of the day, dominate the process.

4.3 Assessing investor's risk tolerance through questionnaires

Another method, which is the main tool to assess the risk tolerance in the asset management industry, are questionnaires. A typical questionnaire is not less than 10 and not more than 25 questions. It may be a subjective assessment of the motives of one's behavior associated with the risk. Can detect certain associations or try to make a subjective assessment of past events. Respondents can be asked to qualitatively or quantitatively describe a situation from the past, or present their most probable behavior in a hypothetical situation. They are as well subject to questions regarding their employment, their level of income as well to questions related to their family.

When drawing up the questionnaire, it is necessary to implement the knowledge of human behavior and their relationship to risk. It can be helpful to avoid serious mistakes. For

instance, Nigel Nicholson's research in 2002, showed a surprisingly insignificant relationship between the risk tolerance and various human activities. The survey across 1600 respondents showed that the correlation between risk tolerance in investments, and risk taking in the sport field was equal to only 0.196. For instance, a situation where a reckless skydiver invests only in the most reliable government bonds, should not be surprising, "*individuals are not universally risk tolerant (or risk averse) in all areas of their life*" (Grable & Rabbani, 2014. p. 174)

Another error that might arise in the using of questionnaires is because of the peculiarities of probability perception, such as systematic re-evaluation of small probabilities. Finally, investors could be not enough financially informed to understand specific concepts such as "volatility" or "Standard Deviation". They might be embarrassed to admit it, hence, misinterpret the question. Obviously, the results of the analysis would be quite inaccurate, being on misinterpreted questions.

Considering a few examples of questionnaires actively used for assessing the risk tolerance in the Western countries. The questionnaire of Vanguard⁷⁰ company (Annex 1) consists of 11 questions. Three of them are associated with the investment horizon and identify the approximate time before having to spend the money invested, the period for which these funds will be spent. Another four questions identify investor's attitude toward asset volatility and expected behavior in case of a distress on stock or bond market. Other questions are related to the investor's trust in other's opinion, the confidence he puts in a unqualified person's advice related to the investments he should make in the future. The remaining question are related to how stable are his current and future revenues; how experienced he is in the financial markets. Last question required to choosing between alternatives - three hypothetical scenarios for a one-year investment.

On the basis of the responses, it immediately calculated the recommended asset allocation for short-term reserves, bonds and stocks. The investor is not informed about his

⁷⁰ "*One of the world's largest and most respected investment companies*" with "*About 280 low-cost traditional funds and ETFs and also 16 locations worldwide with more than 14,000 crew members*" – source: <https://vanguard.com>

presumed level of risk-tolerance at the end of the day, he only receives a recommended proportion of stocks and bonds he might take into account when building his future portfolio. The questionnaire is available online, and every soon-to-become investor can fill it in and receive a recommended investment strategy in about 2 minutes.

The result of filling in the questionnaire in quite a conservative way, also being not quite skilled in financial matters, and having a current allocation of 100% short-term reserves – the algorithm had suggested (taking into account the responses) to invest future savings as follows:

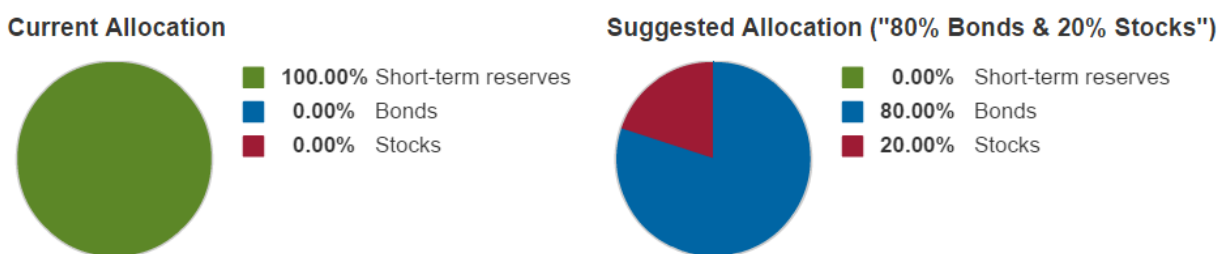


Figure 4. 4 Suggested investment strategy after the compilation of investor questionnaire
Source: vanguard.com

Undoubtedly, the process of filling the questionnaire and, in general, the triviality of the recommendations leave no doubt about how seriously should the investor take the advised strategy.

In fact, the low credibility of questionnaire of such companies as Fidelity, Vanguard, A. G. Edwards s have been demonstrated by Ken Yook⁷¹ and Robert Everett⁷². In 2003, they published a research showing that the mean value of the correlation between risk tolerance estimate of the same people 6 in every one of the companies is equal to 0.56. This leads to the conclusion that each of the companies measure their “version” of risk tolerance, not the unique psychological characteristics of the person.

⁷¹ Associated professor at Johns Hopkins Carey Business School

⁷² Professor of Finance, Lock Haven University of Pennsylvania, Dept. of Business Administration

Quite different looks the questionnaire FinaMetrica, and Australian company which specializes in a scientifically based risk tolerance assessment. Their questionnaire consists of 25 questions (please see Annex 2), including a variety of questions also related to the individual perception and emotions. Filling it in is often necessary to express the attitude to the problem of risk attitude, formulated in a rather unexpected way. For example, it is proposed to reflect on feelings that emerge after making significant financial decisions. The answers are assigned specific numerical values, then added to give specific weights – resulting in the value of risk tolerance, a number from 0 to 100. FinaMetrica’s questionnaire is calibrated for more than 20 thousand people. Companies are using the FinaMetrica questionnaires around the globe since 1998 until present days.

Taking a look at such big banking groups as UniCredit S.p.a and Intesa Sanpaolo questionnaires for a natural person (Annex 3 and 4) we reveal the same image. Meanwhile the Intesa Sanpaolo questionnaires is quite complex addressing many issues, Unicredit’s one seems quite short and does not cover all the MiFID requirements,

For all the questionnaire’s shortcomings used by the financial industry to assess risk tolerance, there’s an undeniable value of them as an educational tool for the potential investor. This is especially true for the questionnaire FinaMetrica, filling in which, a person begins to much better understand the meaning of the risk. He has an opportunity to compare his life goals and financial capabilities, calibrate own ideas about the investment characteristics of various asset classes in line with real market data on their volatility and return, and even to understand what aspects of the investment process cause him the greatest discomfort. To improve the educational function of the questionnaires assessing risk tolerance, it is best to use graphical tools, such as the visualization of the distribution of returns. In this case, the visual picture allows the investor intuitive enough to compare different levels of profitability, estimating the probability of realization of these values.

Chapter 5 MiFID Questionnaires

The end of year 2015 had been marred by the issue arising around 4 small Italian banks, such as: Banca Etruria, Banca Marche, Cassa Ferrara e CariChieti. The mentioned banks had to be rescued, with the involvement of shareholders and stakeholders, including the holders of riskier bonds. The apex of this situation was represented by high distress to the stakeholders, and the subsequent exchange of accusations between Italian and European institutions on how to save the banks in question. The European Commission stated, after the analysis of the situation, that the four banks had been selling financial products that were inappropriate for their clients' risk profile. The banks were found guilty of selling risky products even to those clients deemed to be little prone to risk.

A share of the fault lies on the clients as well, who often did not even know what they had in the portfolio. They invested superficially, without knowing well the risks they faced. The situation showed that there is huge information asymmetry between the parties, and this issue had to be treated.

The fact that, maybe even filling in the questionnaire the investment company was requesting, the client may have not understood the questions, hence the profile of risk for the client was wrong, even if judged effectively by the bank manager gave rise to the problem of evasive responsibility. Should the client's risk profile reveal to be not accurate, or all the way incorrect – the intermediary will not be blamed for ineffectively judging the client. This might be due to the building of an quite difficult questionnaire, containing nonspecific questions that might confuse the client. With its implementation, the second directive is implying that there are to be made changes to the questionnaires, their structure and questions in order to better assess the risk tolerance level of the client prior to offering any investment advice.

5.1 Descriptive and content analysis

The fact that MiFID gives only a quite suggestions, as seen in previous chapter, not denoting specifically how the clients should be assessed and what questions are to be put into the questionnaire. It does not also provide the questionnaire itself as an example. Thus, the banks are to build their own questionnaire, having the norms of MiFID as a guide. This may result in a quite subjective assessment. This is because the banks have their own algorithms, thus the risk profiling of the clients does not coincide across Italian investment companies. Some of the questionnaires were found to be longer, more analytical when the questionnaires of the other investment companies were quite short and concise.

Nicoletta Marinelli and Camilla Mazzoli in their research paper have analyzed 14 questionnaires of 14 investment companies⁷³ that cover 90% of the market. Their findings relate the fact that there is quite a discrepancy⁷⁴ in terms of number of question, their type, and regarding the coverage of MiFID requirements. As such, they find that the range of questions in the questionnaire varies from 9 to 37, the most companies being focused upon a media of 19 questions.

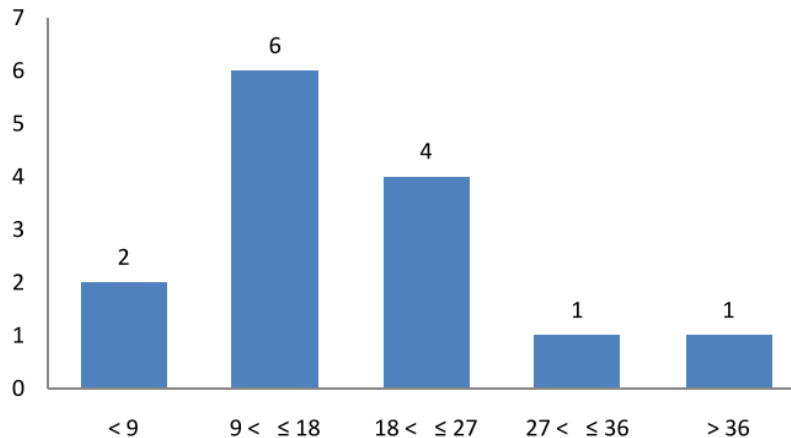


Figure 5. 1 Nr. of questions in the sample's questionnaires
Source: Marinelli and Mazzoli (2011)

⁷³ The authors did not reveal the names of the companies of their sample analysis.

⁷⁴ "Profiling investors with the MiFID: current practice and future prospects" by Marinelli N. and Mazzoli C. (2011)

As of the fact of coverage of the MiFID requested areas, each financial intermediaries (from the sample of 14 investment companies) their findings show that only one company has implemented a full coverage with its questionnaire.

After the analysis of MiFID requests, the authors denoted there are at least 13 questions needed to be asked from an investor, all of them broken down into 3 main sections, as follows:

<i>Section</i>	<i>Should include</i>
Investment objectives	<ul style="list-style-type: none"> • Information on the length of time for which the client wishes to hold the investment • The investor’s preferences regarding risk taking • His/her risk profile⁷⁵ • The purpose of the investment
Financial capacity	<ul style="list-style-type: none"> • Source and extent of his or her regular income • His or her assets (including liquid assets) • Investment and real property • His or her regular financial commitments
Experience and knowledge	<ul style="list-style-type: none"> • Types of service, transaction and financial instrument with which the client is familiar • The nature, volume and frequency of the client’s transactions in financial instruments • The period over which the client’s transactions have been carried out

⁷⁵ “we associated the ‘preferences regarding risk taking’ item with all the questions related to the risk and return characteristics of the investments the client is willing to undergo (objective risk), while we interpreted the ‘risk profile’ item as the one aimed to know the behavior of the client in situations of riskiness and uncertainty (subjective risk)” Marinelli and Mazzoli (2010) regarding the “risk profile” clause in the suggested items.

- The level of education of the client
- Profession or relevant former profession of the client.

Table 5.1 Set of suggested items for a questionnaire
Source: Marinelli and Mazzoli (2011)

The results were quite far from perfect.

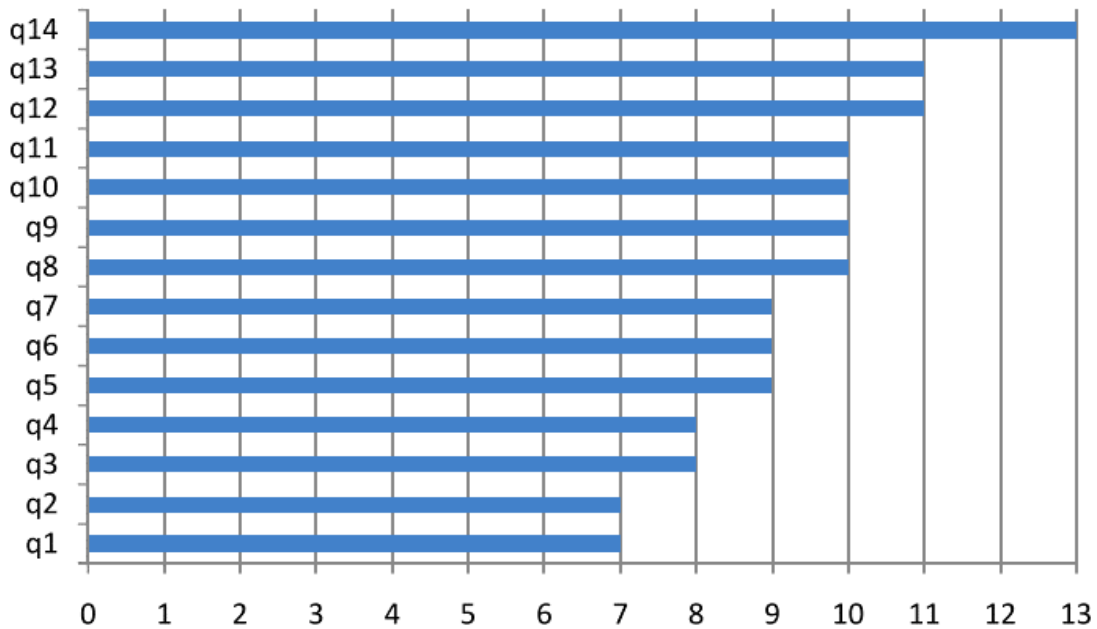


Figure 5.2 Completeness of the suitability questionnaires of the Italian investment intermediaries
Source: Marinelli and Mazzoli (2011)

According to the data, only one of the 14 companies did indeed cover all the areas and items relevant for building a correct risk profile, according to the MiFID requirements. As of the entire of sample, each of the companies in their suitability questionnaires covered 7 questions out of 13.

“less investigated areas are those regarding: regular financial commitments (seven questionnaires), the asset composition (six questionnaires), the risk profile (four questionnaires), the period over which past investments have been carried out (one

questionnaire). Some intermediaries provide ‘extra’ questions, not included in the ‘benchmark’ scheme suggested by MiFID.” (Marinelli and Mazzoli (2011)

This will undoubtedly result in inaccurate results, inaccurate profiling and overall in an inaccurate investments strategy for the clients. As the data shows, having such a poor coverage of the MiFID requirements it is expected that a person will be profiled differently in each of the companies from the sample.

In France, the same questionnaires analysis was performed by André de Palma and Nathalie Picard for the Autorité des Marchés Financiers (AMF). Their purpose of study was to reveal a “*diagnosis and an objective and quantitative measurement of the reliability of the main tools that financial institutions have designed to evaluate risk profiles.*” (De Palma and Picard, 2010)

based on the sample 14 questionnaires of the 12 companies reported as follows:

- Association des Petits Actionnaires Indépendants (APAI)
- BNP Paribas
- BPCE
- CGPLand
- Chambre des Indépendants du Patrimoine
- CM5-CIC
- Cortal Consors
- Crédit Agricole SA
- HSBC
- Lazard
- Rothschild
- Société Générale

According to the two scholars, out of the 14 questionnaires analyzed – there was a compliance with the following.



Figure 5.3 Completeness of the suitability of the French investment intermediaries questionnaires
 Source: Self elaborated based on results of De Palma & Picard, 2010

As reported, all the questionnaires had a part of the question concerning the experience/knowledge the clients possessed in the investment field. Nonetheless, *“the questions deal more with experience than with knowledge, and they rarely address the two complementary facets of experience, namely objective and subjective experience.”* (De Palma & Picard, 2010)

For the Principal Component Analysis, each of the questionnaires have been assigned a letter, then analyzed related to two main dimensions:

1. Focus on client's financial situation, purpose of the investment as well as client's risk appetite. (horizontal)
2. Focus on client's experience, financial literacy, and knowledge related to the investment activity (vertical)

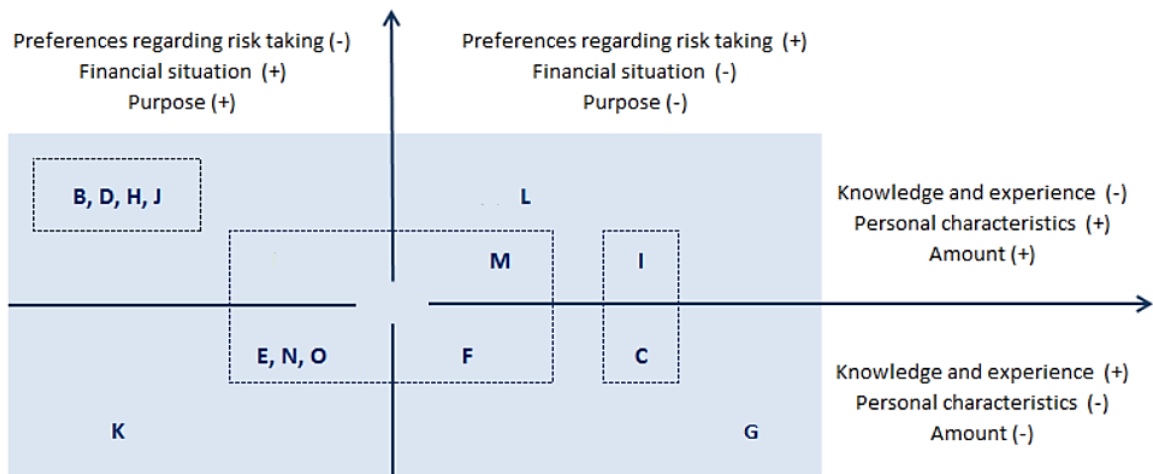


Figure 5.4 Principal Component Analysis of the French investment intermediaries' questionnaires
 Source: De Palma & Picard, 2010

The results of the analysis has reported three main clusters. These three groups of are formed by the questionnaires that are particularly comparable among them.

- As follows, four of them (B, D, H, J) focus strongly on the client's financial situation and characteristics, not quite putting the emphasis on the personal characteristics of the investor.
- The other five (E, N, O, F, M) form a group, positioned in the center, which denotes the fact that they are fairly focus on all the client's characteristics, as well as financial situation. They represent the "golden middle".
- The third cluster (I, C) are on the opposite sides of investment amount importance, but all the same putting lots of emphasis on the his risk profile.
- The remaining three questionnaires (K, L, G) are scattered across the axes, which relates the fact that, at the end of the day, the questionnaires are not homogenous across the companies.

The results of these analysis shows that the companies have not taken slightly MiFID's indications when building their questionnaires. Both analyses have emphasized a high level of compliance of the questionnaires, both by Italian and French companies, with MiFID clauses, also reporting that the companies went a further, requesting information not even

suggested by MiFID as a requirement. This shows that “*the financial institutions concerned did not settle for doing the minimum to comply with MiFID.*” (De Palma & Picard, 2010) Even if, at the time, it has been received as an indication of intermediaries effort and responsibility to provide a healthy investment advice to their client, it unfortunately shows that the directive lack specificity and precision, and must be revised as to fix that.

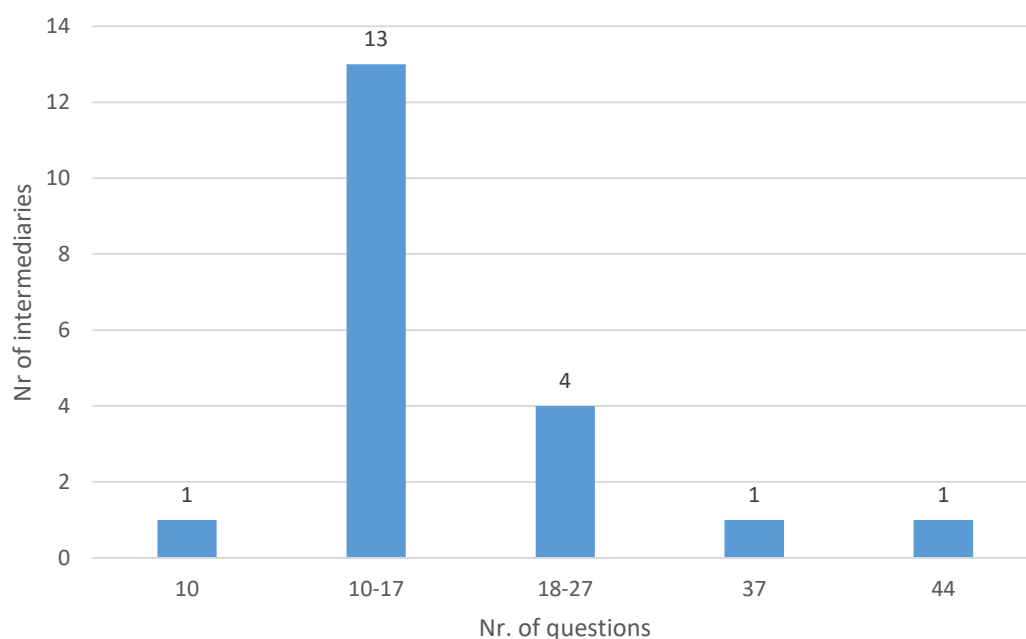
In their findings Marinelli and Mazzoli (2011), related to the sample of 14 Italian banks report the same finding. According to the descriptive analysis, they stipulate “*the implantation of the suitability assessment, even though recognized as a common MiFID regulator requirement, is applied in a highly variable manner by [the] sample of Italian firm. The differences that do exist may stem from fact that supervisors give only a general rule for the development of the suitability questionnaire, without providing a unique and shared form, in adherence to a prudential regulation approach. As a consequence, each intermediary may develop its own suitability questions according to:*

- *Business model: the propensity to ask for some information may vary depending on the kind of business that characterizes each intermediary; [...]*
- *Compliance function: the specific question included in the questionnaire may also depend upon how the compliance function of the firm interprets the regulatory recommendation and the relevance accorded to specific aspects of the application law.*
- *Competence level of the front office: as front offices are the bridge between the firm and the customer in the implementation of the suitability questionnaire, a different approach to the development of the questions may also depend upon the specific competence of the front offices in terms of technical advice, ability to build a relationship and commercial approach to the client*
- *A random component that does not depend upon a strategy or rational motivation by the firm but just upon erratic occurrence or the behavioral biases in the people*

assigned to the development of the questionnaires itself “ (Marinelli and Mazzoli⁷⁶, 2011, p. 232)

The same research was, subsequently, made by the Linciano N. and Soccorso P. in July 2012, under the CONSOB, Research Division, Economic Research Unit. Their data was fully in line with the findings of the 4 scholars mentioned above.

The authors have based their analysis on 20 questionnaires from Italian financial intermediaries.⁷⁷ Their structure, length and level of compliance also varied across companies.



*Figure 5.3 Completeness of the suitability of the French investment intermediaries questionnaires
Source: Self elaborated based on results Linciano N. and Soccorso P (2012)*

⁷⁶ “*Bank Strategy, Governance and Ratings*” book by Molyneux P., section by Marinelli N and Mazzoli C.

⁷⁷ The financial intermediaries used in the sample were not disclosed by the authors.

As can be seen from the table above, they most compact one was only constituted from 10 questions, the most complex one – was 47 questions. On average, though, the companies settled for a number in the range of 10 – 17 questions. The authors have then proceeded with dividing the questionnaires in three areas, as before, then analyze the compliance with the second level (L2) of the Directive.

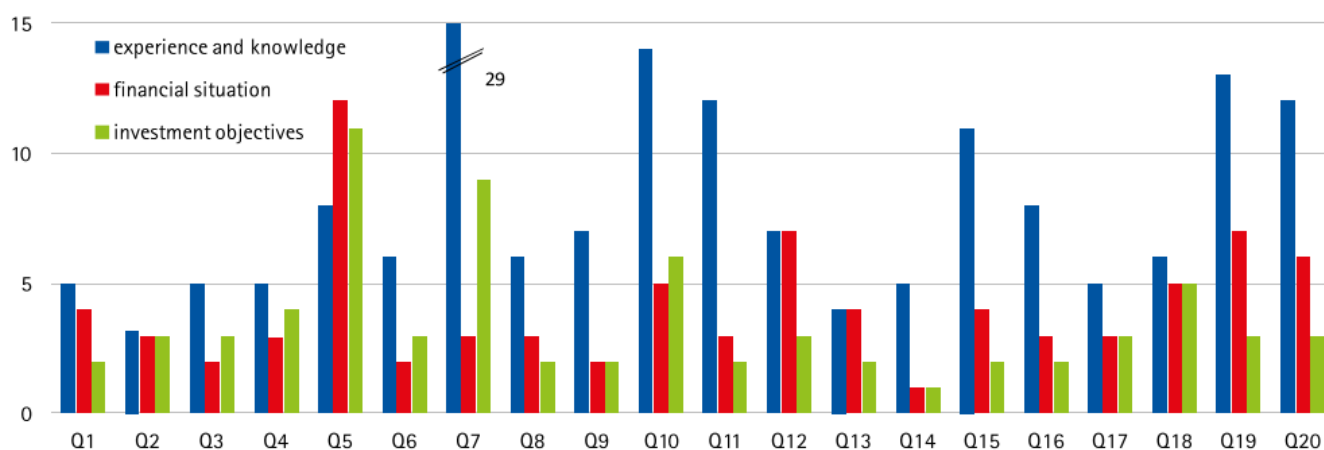


Figure 5.4 Number of questions per section
Source: Linciano N. and Soccorso P (2012)

The authors then denote that *“the questionnaires cover each subject with at least one question. All questionnaires do, however, ask at least one question relating to which products/services the client is familiar with.”* following with *“least detailed section is that relating to investment objectives: only 13 questionnaires contain (at least) one question on risk preferences (objective risk); only 10 refer to the risk profile (subjective risk).”* (Linciano N. and Soccorso P., 2012)

The findings of the two authors for this research was in line with the two previous ones. Indeed, the questionnaires appear to be not complex, they do not seem to cover all the needed areas - they leave room for subjectivity and error. Also, as the two scholars stipulate *“they comply with the provisions of the MiFID, and are consistent with the Directive itself, most questionnaires are not aligned with the economic and psychological literature; in addition*

their clarity and comprehensibility are flawed by some linguistic-textual characteristics” (Linciano N. and Soccorso P. 2012 p. 36)

The findings of research papers from all across EU may have been the main reason why ESMA in 2012 has published the “*Guidelines on certain aspects of the MiFID suitability requirements*”. The authorities, thus, understood the limitation of the questionnaires and the subjectivity with which they were built in every investment company. The guidelines were published as a recommendation as to “*how to get your customer better*”.

The main limitations, according to ESMA were related to the fact that the procedure of financial strategy advice was inadequate, and in drastic need of change. Moreover, the intermediaries were said to inaccurately assess the level of knowledge and experience the client presumed to have. Often, they left the assessment of the knowledge to the client itself – trusting in one’s self-assessment. The guidelines specified that the intermediaries have to ensure that “*the client understands the notion of investment risk as well as the relationship between risk and return on investments*”⁷⁸ This is compulsory, as it then stipulates that the firm must use comprehensible, indicative examples to ensure a good understanding of market functioning. ESMA then continues stating that it is the firm who decides the suitability of the financial product for the client, never to leave it to client’s subjectivity anymore.

⁷⁸ ESMA, guidelines 1 - Clause 16

5.2 An questionnaire's algorithm

As previously discussed, there is a strong need to assess the risk of the clients prior to establish any working relationship with them. The investment companies use the questionnaires in order to do so. This will allow them to not only to correctly assign suitable investment products for the client, but also to correctly understand the client as a person, its objectives and the level of risk to undertake his financial situation etc.

There is undoubtedly a range of limitations of the questionnaires, but as of now, it is the only working tool the investment companies might use to build a client's risk profile. The financial intermediaries are putting together a puzzle, as to create a overall picture of their future client. The method of directly asking the investor "*what is the level of your risk tolerance?*"⁷⁹ provides a quite inaccurate, superficial representation due to the investor's subjectivity, over-confidence or other psychometric information. Unfortunately this is the case for most questionnaires in the world.⁸⁰ As discussed in the chapter above - including the behavioral data is vital for correctly building a client's profile.

As seen from the paragraph 5, the regulators did not provide a questionnaires to be used, but only indication as of what precisely to ask of the client. This lead to the fact that banks have built their own questionnaires, and also algorithms as of how to interpret the client's answers.

The standard process of risk profiling is reported as follows:

⁷⁹ A research of Neuroprofiler based on 504 questionnaires across 50 countries revealed "49% of them evaluated risk tolerance directly with the question: "What is your risk attitude?" or "Which option best describes your risk attitude?". Only 54% took loss aversion into account." Obviously, such a question will most likely provide erroneous data to the manager, which will also result in a biased strategy for the client, unsuitable to his risk tolerance and risk appetite level – source: <https://neuroprofiler.wordpress.com>
Neuroprofiler is a French company developing online application, using the behavioral finance to correctly determine the client's risk profile.

⁸⁰ "131 questionnaires from investment firms and advisers in the United States, and his findings are troubling, to say the least. The most troublesome finding is that 11% of the questionnaires [...] explicitly asked the investor to select a specific risk profile or portfolio" – source: Klement J (2015) quoting the results of Rice D.F (2005) of his research based on 131 investment firm's questionnaires from the USA.

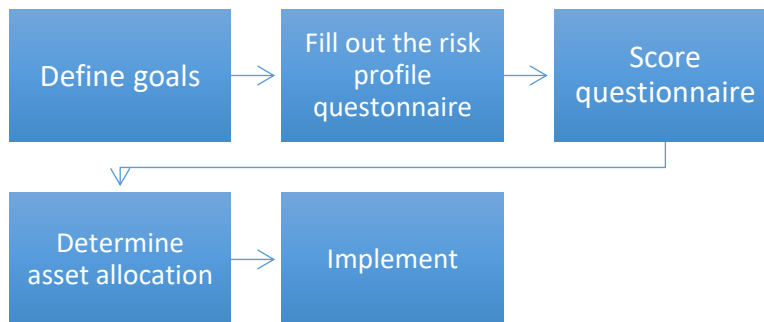


Figure 5.5 Number of questions per section
Source: Klement (2015)

The process of building a working relationship with the client usually starts with defining the goals of the client. As per usual the manager will be also have a first discussion with the client, prior to filling in the questionnaires, *“usually begins with definition and discussion of the investor’s situation and the goal(s) that are to be achieved by the investments or portfolio.”* Klement (2015)

“Questionnaires, in conjunction with lengthy conversations with the client at the beginning of the process, ultimately lead to crucial decisions that will set the boundaries for the portfolio” during which *“managers should have backup materials and charts to educate clients on what is reasonable and to quantify some of the clients’ thoughts about objectives.”* (Spero, 2000)

The most difficult it’s the phase number three in which financial intermediaries implement a quantitative assessment of the qualitative data. Based on the responses provided by the client, they are assigning a specific Value at Risk (VAR) to the client. It is quite enigmatic to understand the mechanism, but for obvious reasons, investment companies do not make public such information.

The companies will use a scoring mechanism to assign a weight for each of the responses in the questionnaires. Klement (2015) quoting the findings of Rice, D.F. (2005)⁸¹ stipulates that the research based on 131 questionnaires from USA investment firms have showed that the companies assigned an scored in quite a subjective way. *“Scoring was generally done on an equal-weight basis, even though some questions might have been clearly more important in determining the risk profile than others. Similarly, the confidence an investor had in specific answers was ignored in every instance, even though the abstract nature of the questions might lead to large variations in confidence levels. Finally, the determination of the resulting asset allocation seems to be typically done in such a way as to benefit the investment firm rather than the investor. [...] When hen all questions in the questionnaires surveyed were answered in the most conservative way, the allocation to equities ranged from 0% to 70%.”*

The fact of attributing the same weight to all the responses is, without doubt, erroneous. As can be seen from the chapters above, a person who is nearing the retirement age is less eager to take on risks. In addition, the level of income has a great influence on the amount the investor is ready to put to risk. Assigning equal weight to age ranges and income ranges will result in inaccurate results, and erroneous strategies, which will not reflect the level of risk tolerance of the client. An investor with age in between 25-35 years, with a high level of income will most likely have a different risk tolerance level rather a 70 years old person, who wants to preserve his wealth, thus invest in most secure financial products. Also the firm have to also take into account the cognitive and emotional biases, that will surely have a strong impact on the results accuracy.

Another analysis published in 2014 of the 180 000 brokerage accounts from Canada, realized by Foerster, Linnainmaa, Melzer, and Previtero showed that the advisors had a better influence than the investor itself. The authors stipulated that *“standard regressions that took into account risk tolerance (as indicated by answers to simple hypothetical questions), investor time horizon, financial knowledge, income, net worth, age, gender, and occupation*

⁸¹ Rice, D.F. (2005). *"Variance in Risk Tolerance Measurement—Toward a Uniform Solution."* PhD Thesis, Golden Gate University.

could explain only 13.1% of the variation in the share of risky assets in investor portfolios. When the influence of the adviser was taken into account, the share of variation in risky assets that could be explained rose to 31.6%. In other words, the adviser turned out to be a more influential factor in the makeup of investor portfolios than the factors typically evaluated in a risk-profiling questionnaire. Similar results were obtained for the home bias in investor portfolios.” (Klement, 2015)

As overall, the scholars all over the world, realizing quantitative analysis based on suitability questionnaires have reached the same conclusions, that the use of questionnaires for determining the level of risk tolerance of the client has proven to be unreliable. *“the differences in the questionnaires may produce dramatic effects on investors: they could be profiled as ‘cautious’ by one financial firm and ‘dynamic’ by another. The differences that do exist may stem from the fact that supervisors give only general rules for the development of the questionnaire without providing a unique and shared form, in adherence to a prudential regulation approach.”*

Regulators all around the globe have received a tremendous amount of complaints regarding the erroneous investment strategies and unsuitable financial products. The same authors refers to the UK Financial Ombudsman Service which has received *“2,079 complaints in relation to stock broking and portfolio management, with suitability questions being the main cause of problems [...] The office of the Ombudsman at FINRA counted 1,283 complaints about allegedly unsuitable investments between January 2014 and November 2014”* (Klement, 2015). He then stipulates that during the financial crisis, which shook the foundations of the world in 2007-2008, has considerably decreased. This might be due to the fact that *“as long as the investments make money for the investors, suitability issues are not noticed or ignored. Once markets start to shake, the fragile foundations of investment advice as practiced today start to give way”* (Marinelli and Mazzoli , 2011)

ESMA related the problem in its guidelines, specifying that *“regulators in major EU markets have found that up to 90 % of assessments of clients’ risk tolerance, for example, were invalid and unreliable, which led to unsuitable investment advice, provided to clients”*

(ESMA, 2014). The regulators then required that each bank reviewed his questionnaires, eliminating the possibility for risk profile mismatching.

5.3 Robo-Advisors: reducing the Financial Advice Gap

In recent years, as the limitations of questionnaires became more evident, there was a surge of the robo-advisors. They are threatening to take over the traditional financial advisement. According to latest data, the robotic algorithms gained ground, and are expected by 2020 to manage more 10% of the global asset.⁸²

Robo-advisors are defined as “*automated investment services that use algorithms to manage and allocate people's assets. Robo-advisor software analyzes an individual customer's current financial status, risk aversion, and monetary goals, and then recommends the best portfolio of stocks available based on that data.*”⁸³

It is believed that, with time passing by, more and more of the companies will rely on the automated systems to provide investment strategies for the clients. Companies have already started to implement such algorithms in place. One of such was Betterment, implemented in 2008. The robo-advisors are already substituting the investment managers.

As of 2015 there can be noticed an increasing trend in implementing the system of digital advisement. According to the data, during 2015 in USA more than 44 financial intermediaries have implemented a digital advising system:

⁸² According to Business Insider' Intelligence analysis.

⁸³ Source: <http://www.businessinsider.com>

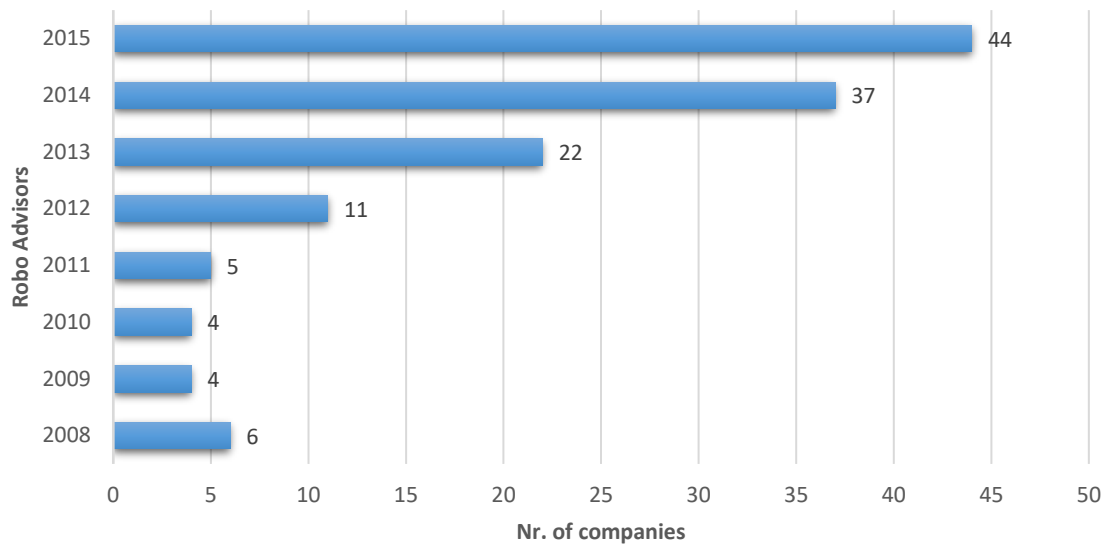


Figure 5.6 Financial Advice Gap
Source: BlackRock

It was to be expected, since the new generation of investors are used to have the information needed at their fingertips, just enough that they have a working internet connection. This was unthinkable 20 years ago, when there was a strong informational asymmetry between the two members: bank manager and investor. The former had access to necessary information he needed to provide an investment advice, meanwhile the latter did not, hence were strongly uninformed. This changed in the last years – now the information is just a *click away*.

According to banking regulators, the robo-advisors may be used in determining the profile of private investors. The development of robo-advisors platform is left to self-regulatory organizations. However, the Banking regulators will participate and supervise the building of the algorithms. This gives the certainty that there will be no room for subjectivity nor manipulation, instead ensuring a certain level of standardization and homogeneity on the market.

The latest years is characterized by the rise of era of “*digital advice*”. Profiling by robo-advisors is quite convenient for brokers - more and more people are opening accounts

remotely, by accessing internet. Automated systems will make the market more transparent and understandable to investors, reducing the *financial advice gap*.

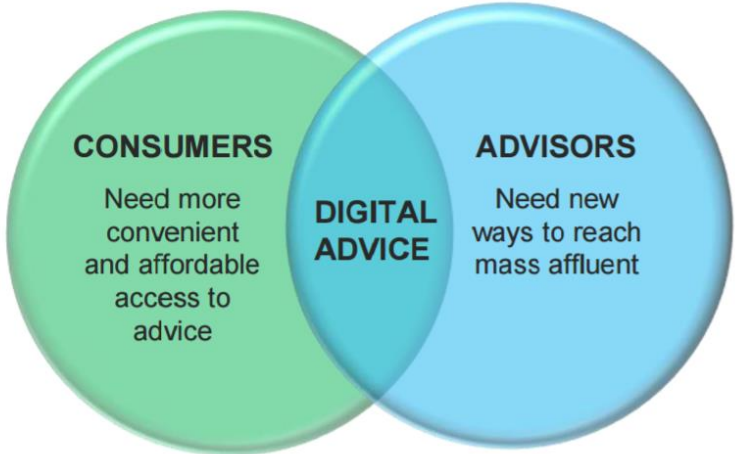


Figure 5.7 Financial Advice Gap
Source: BlackRock

*“Digital advisors have a number of different investment philosophies, methods, and strategies. The algorithms fueling digital advice vary in terms of sophistication. Algorithms can range from a simple or pre-packaged algorithm that builds a single portfolio to a complex multi-strategy algorithm that reviews thousands of instruments and scenarios in order to construct an aggregate portfolio based on an individual’s current holdings, investment horizon, and risk tolerance.”*⁸⁴

The robo-advisor will also follow the same methodology/steps of investment, summarized as: first allocate the assets, implement, monitor and adjust if needed. Is the same 3 step methodology used by investors all across the world, whether individual or institutional.

As of now, the robo-advisors present an interesting and compelling possibility for both financial intermediaries as well as clients. They are easy to implement, quick, give the possibility to the bank to provide investment advice via internet and to the client to not be forced to physically go to the bank. Their advice will be correct, according to the literature

⁸⁴ BlackRock Inc. publication on “*Digital Investment Advice: Robo Advisors Come of Age*” - 2016

unbiased transparent but, for all their possibilities, they also offer a range a limitations. Specifically, a machine will still not be able to perceive little emotional details the client might reveal unwillingly during his discussion with the bank manager. Should the manager find a mismatch between client's words and his behavior – he will have the possibility to adjust and change the strategy. The machines, obviously, do not bring is such details.

Conclusions

This thesis' purpose was to analyze the changes between the two Markets in Financial Instruments Directives, specifically Directive 2004/39/EC - referred to as MiFID I, and the Directive 2014/65/EU – referred to as MiFID II, which consists of a of Directive itself and the Regulation 600/2014 (MiFIR), both of which will come into force on 3rd of January 2018. The new Directive's represents, in fact, a revised version of MiFID I, enlarging its scope and coverage, all the while bringing fundamental changes in financial market of the EU, which has found to be quite flawed, as the financial crisis of 2007-2008 revealed.

By implementing the new Directive, the European Regulators focused on filling in the gaps left uncovered by the first Directive, ensuring a healthier investment environment for market participants. The key changes introduced by MiFID II are related to a) providing an increased level of competition in the financial markets which is expected to favor the investor; b) establishing a functioning market structure framework with respect to trading venues - RM, MTF and OTF b) homogenize regulations across European Union; c) increase market transparency; d) address the issue of Algorithmic Trading and High Frequency Trading

However, the main focus was placed on ensuring an increased level of investors protection. The new Directive specifically addresses the *suitability* and *appropriateness* analyses – two concepts and building blocks of Investment Advice Service provided by financial intermediaries. The two aforementioned analyses are vital for providing a sound investment strategy and portfolio management.

In conducting the analyses, the financial intermediaries are bound to use the *questionnaires* – financial tools for evaluating the client's ability to bear losses, his risk appetite and level of risk tolerance. As previously discussed during the fourth and fifth chapter - the findings of many researches regarding the reliability of such questionnaires has proven it to be quite low. As stipulated, the lack of specific indications from the regulators regarding how to correctly perform the two analyses had a tremendous impact on the results

accuracy. This has also risen the problem of complete divergence between the questionnaires, even of companies working in the same industry. Their contents and structure differs largely from one to another – some had only 10 questions, others arrived to over 44, some of them are more focused on personal characteristic of the client, other more on the financial characteristic. The providers of investment strategies are then obliged to also build their own algorithm of understanding a level of risk tolerance to the client. These divergences among the questionnaires leave room for error regarding client's risk profile. A client might be profiled as extremely “risk-averse” or by one financial intermediary and as quite “risk-seeking” by other. This will result in a erroneous investment strategy, and unsuitable products advised for investing in. The client might be subject to higher risk than acceptable. Also having a unfitting strategy of portfolio management will not allow the clients to reach their goals, which will make them unhappy. From a point of view of company's reputation – there's nothing that can be more harmful than unsatisfied clients.

A way of solving the issue might be the financial Regulators who will provide the market with a standard questionnaire. With the rise of behavioral finance, questionnaires have to become more “broad”, thus include not only questions related to the client's age and level of income for instance, but also include questions related to the investor's personality. The provision of such standardized questionnaire will most likely not be possible, even if it would solve many raised issues regarding their reliability. Instead, investment companies prefer to either to implement theirs and perfect him under the new requirements, or to use such models of questionnaires like Betterment, FinaMetrica or Vanguard's – which already implement the part regarding the behavioral finance, with the effort to provide reliable and trustworthy results as as for the company, as well as for the client, increasing his level of protection.

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Abbreviations

CESR - The Committee of European Securities Regulators

CLFI - Consolidated Law on Financial Intermediation of CONSOB

CONSOB - Commissione Nazionale per le Società e la Borsa

ECB - European Central Bank

ESCB - European System of Central Banks

ESMA - European Securities and Markets Authority

EU - European Union

ISD - Investment Services Directive

ISVAP - Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo

IVASS - Istituto per la vigilanza sulle assicurazioni

MiFID - The Markets in Financial Instruments Directive

SIM - Società di Intermediazione Mobiliare

TUB - Testo Unico Bancario

TUF - Testo Unico della Finanza

RTS - Regulatory Technical Standards

ITS - Implementing Technical Standard

RTS - Regulatory Technical Standards

ITS - Implementing Technical Standards

DD - Delegated Directives

DR - Delegated Regulations



Investor Questionnaire

1. I plan to begin taking money from my investments in . . .

- 1 year or less
- 1 – 2 years
- 3 – 5 years
- 6 – 10 years
- 11 – 15 years
- More than 15 years

2. As I withdraw money from these investments, I plan to spend it over a period of . . .

- 2 years or less
- 3 – 5 years
- 6 – 10 years
- 11 – 15 years
- More than 15 years

3. When making a long-term investment, I plan to keep the money invested for . . .

- 1 – 2 years
- 3 – 4 years
- 5 – 6 years
- 7 – 8 years
- More than 8 years

4. From September 2008 through November 2008, stocks lost over 31%. If I owned a stock investment that lost about 31% in 3 months, I would: (If you owned stocks during this period, select the answer that corresponds to your actual behavior.)

- Sell all of the remaining investment.
- Sell a portion of the remaining investment.
- Hold onto the investment and sell nothing.
- Buy more of the investment.

5. Generally, I prefer investments with little or no fluctuation in value, and I'm willing to accept the lower return associated with these investments.

- Strongly disagree
- Disagree
- Somewhat agree
- Agree
- Strongly agree

6. During market declines, I tend to sell portions of my riskier assets and invest the money in safer assets.

- Strongly disagree
- Disagree
- Somewhat agree
- Agree
- Strongly agree

7. I would invest in a mutual fund based solely on a brief conversation with a friend, co-worker, or relative.

- Strongly disagree
- Disagree
- Somewhat agree
- Agree
- Strongly agree

8. From September 2008 through October 2008, bonds lost nearly 4%. If I owned a bond investment that lost almost 4% in 2 months, I would: (If you owned bonds during this period, select the answer that corresponds to your actual behavior.)

- Sell all of the remaining investment.
- Sell a portion of the remaining investment.
- Hold onto the investment and sell nothing.
- Buy more of the investment.

9. The chart below shows the greatest 1-year loss and the highest 1-year gain on 3 different hypothetical investments of \$10,000.* Given the potential gain or loss in any 1 year, I would invest my money in:

- A (loss of \$164, gain of \$593)
- B (loss of \$1,020, gain of \$1,921)
- C (loss of \$3,639, gain of \$4,229)



*The maximum gain or loss on an investment is impossible to predict. The ranges shown in the chart are hypothetical and are designed solely to gauge an investor's risk tolerance.

10. My current and future income sources (for example, salary, Social Security, pension) are:

- Very unstable
- Unstable
- Somewhat stable
- Stable
- Very stable

11. When it comes to investing in stock or bond mutual funds (or individual stocks or bonds), I would describe myself as . . .

- Very inexperienced
- Somewhat inexperienced
- Somewhat experienced
- Experienced
- Very experienced

Your current asset allocation

Enter the current allocation in whole numbers for the savings used to answer question 10. Your percentages must total 100%. If you don't enter any data, the questionnaire will assume 100% of your assets are in short-term reserves.

Short-term reserves	<input type="text" value="100.0"/>	%
Bonds	<input type="text" value="0.0"/>	%
Stocks	<input type="text" value="0.0"/>	%

Cancel

Back Get Results

Risk Tolerance Questionnaire

Please answer all the questions by circling one of the options. Choose the option that best indicates how you feel about each question. If none of the options is exactly right for you, choose the option that is closest.

1. **Compared to others, how do you rate your willingness to take financial risks?**
 - 1 Extremely low risk taker.
 - 2 Very low risk taker.
 - 3 Low risk taker.
 - 4 Average risk taker.
 - 5 High risk taker.
 - 6 Very high risk taker.
 - 7 Extremely high risk taker.

2. **How easily do you adapt when things go wrong financially?**
 - 1 Very uneasily.
 - 2 Somewhat uneasily.
 - 3 Somewhat easily.
 - 4 Very easily.

3. **When you think of the word "risk" in a financial context, which of the following words comes to mind first?**
 - 1 Danger.
 - 2 Uncertainty.
 - 3 Opportunity.
 - 4 Thrill.

4. **Have you ever invested a large sum in a risky investment mainly for the "thrill" of seeing whether it went up or down in value?**
 - 1 No.
 - 2 Yes, very rarely.
 - 3 Yes, somewhat rarely.
 - 4 Yes, somewhat frequently.
 - 5 Yes, very frequently.

5. **If you had to choose between more job security with a small pay increase and less job security with a big pay increase, which would you pick?**
 - 1 Definitely more job security with a small pay increase.
 - 2 Probably more job security with a small pay increase.
 - 3 Not sure.
 - 4 Probably less job security with a big pay increase.
 - 5 Definitely less job security with a big pay increase.

6. **When faced with a major financial decision, are you more concerned about the possible losses or the possible gains?**
 - 1 Always the possible losses.
 - 2 Usually the possible losses.
 - 3 Usually the possible gains.
 - 4 Always the possible gains.

7. **How do you usually feel about your major financial decisions after you make them?**
 - 1 Very pessimistic.
 - 2 Somewhat pessimistic.
 - 3 Somewhat optimistic.
 - 4 Very optimistic.

8. **Imagine you were in a job where you could choose to be paid salary, commission or a mix of both. Which would you pick?**
- 1 All salary.
 - 2 Mainly salary.
 - 3 Equal mix of salary and commission.
 - 4 Mainly commission.
 - 5 All commission.
9. **What degree of risk have you taken with your financial decisions in the past?**
- 1 Very small.
 - 2 Small.
 - 3 Medium.
 - 4 Large.
 - 5 Very large.
10. **What degree of risk are you currently prepared to take with your financial decisions?**
- 1 Very small.
 - 2 Small.
 - 3 Medium.
 - 4 Large.
 - 5 Very large.
11. **Have you ever borrowed money to make an investment (other than for your home)?**
- 1 No.
 - 2 Yes.
12. **How much confidence do you have in your ability to make good financial decisions?**
- 1 None.
 - 2 A little.
 - 3 A reasonable amount.
 - 4 A great deal.
 - 5 Complete.
13. **Suppose that 5 years ago you bought shares in a highly regarded company. That same year the company experienced a severe decline in sales due to poor management. The price of the shares dropped drastically and you sold at a substantial loss.**
- The company has been restructured under new management and most experts now expect it to produce better than average returns. Given your bad past experience with this company, would you buy shares now?**
- 1 Definitely not.
 - 2 Probably not.
 - 3 Not sure.
 - 4 Probably.
 - 5 Definitely.
14. **Investments can go up and down in value and experts often say you should be prepared to weather a downturn. By how much could the total value of all your investments go down before you would begin to feel uncomfortable?**
- 1 Any fall in value would make me feel uncomfortable.
 - 2 10%.
 - 3 20%.
 - 4 33%.
 - 5 50%.
 - 6 More than 50%.

15. Assume that a long-lost relative dies and leaves you a house which is in poor condition but is located in a suburb that's becoming popular.

As is, the house would probably sell for \$300,000, but if you were to spend about \$100,000 on renovations, the selling price would be around \$600,000.

However, there is some talk of constructing a major highway next to the house, and this would lower its value considerably.

Which of the following options would you take?

- 1 Sell it as is.
- 2 Keep it as is, but rent it out.
- 3 Take out a \$100,000 mortgage and do the renovations.

16. Most investment portfolios have a mix of investments - some of the investments may have high expected returns but with high risk, some may have medium expected returns and medium risk, and some may be low-risk/low-return. (For example, shares and property would be high-risk/high-return whereas cash and term deposits would be low-risk/low-return.)

Which mix of investments do you find most appealing? Would you prefer all low-risk/low-return, all high-risk/high-return, or somewhere in between?

Please select one of the seven portfolios listed below.

Mix of Investment in Portfolio

Portfolio	High Risk/Return	Medium Risk/Return	Low Risk/Return
1	0%	0%	100%
2	0%	30%	70%
3	10%	40%	50%
4	30%	40%	30%
5	50%	40%	10%
6	70%	30%	0%
7	100%	0%	0%

17. You are considering placing one-quarter of your investment funds into a single investment. This investment is expected to earn about twice the term deposit rate. However, unlike a term deposit, this investment is not protected against loss of the money invested.

How low would the chance of a loss have to be for you to make the investment?

- 1 Zero, i.e. no chance of loss.
- 2 Very low chance of loss.
- 3 Moderately low chance of loss.
- 4 50% chance of loss.

18. With some types of investment, such as cash and term deposits, the value of the investment is fixed. However inflation will cause the purchasing power of this value to decrease.

With other types of investment, such as shares and property, the value is not fixed. It will vary. In the short term it may even fall below the purchase price. However, over the long term, the value of shares and property should certainly increase by more than the rate of inflation.

With this in mind, which is more important to you - that the value of your investments does not fall or that it retains its purchasing power?

- 1 Much more important that the value does not fall.
- 2 Somewhat more important that the value does not fall.
- 3 Somewhat more important that the value retains its purchasing power.
- 4 Much more important that the value retains its purchasing power.

19. In recent years, how have your personal investments changed?

- 1 Always toward lower risk.
- 2 Mostly toward lower risk.
- 3 No changes or changes with no clear direction.
- 4 Mostly toward higher risk.
- 5 Always toward higher risk.

20. When making an investment, return and risk usually go hand-in-hand. Investments which produce above-average returns are usually of above-average risk.

With this in mind, how much of the funds you have available to invest would you be willing to place in investments where both returns and risks are expected to be above average?

- 1 None.
- 2 10%.
- 3 20%.
- 4 30%.
- 5 40%.
- 6 50%.
- 7 60%.
- 8 70%.
- 9 80%.
- 10 90%.
- 11 100%.

21. Think of the average rate of return you would expect to earn on an investment portfolio over the next ten years. How does this compare with what you think you would earn if you invested the money in term deposits?

- 1 About the same rate as from term deposits.
- 2 About one and a half times the rate from term deposits.
- 3 About twice the rate from term deposits.
- 4 About two and a half times the rate from term deposits.
- 5 About three times the rate from term deposits.
- 6 More than three times the rate from term deposits.

22. People often arrange their financial affairs to qualify for a government benefit or to obtain a tax advantage. However a change in legislation can leave them worse off than if they'd done nothing.

With this in mind, would you take a risk in arranging your affairs to qualify for a government benefit or obtain a tax advantage?

- 1 I would not take a risk if there was any chance I could finish up worse off.
- 2 I would take a risk if there was only a small chance I could finish up worse off.
- 3 I would take a risk as long as there was more than a 50% chance that I would finish up better off.

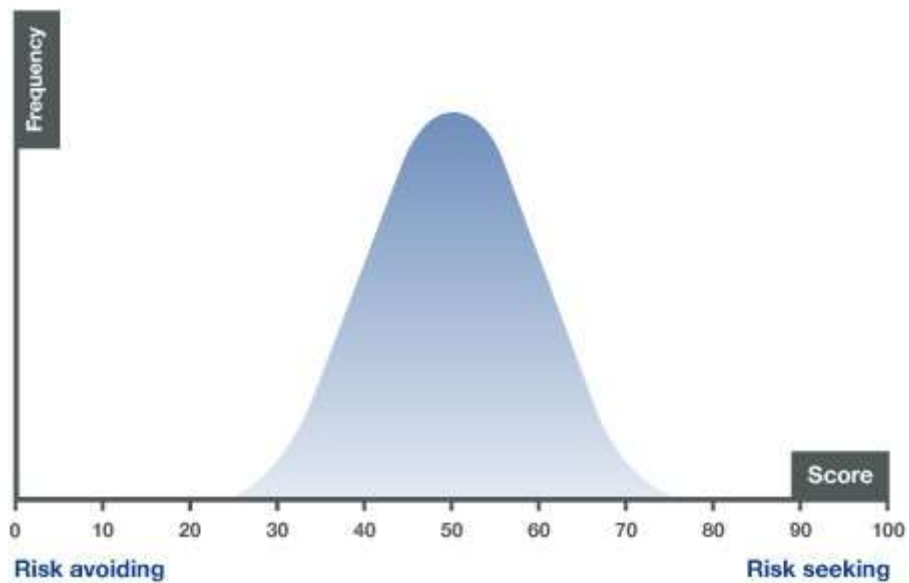
23. Imagine that you are borrowing a large sum of money at some time in the future. It's not clear which way interest rates are going to move - they might go up, they might go down, no one seems to know.

You could take a variable interest rate that will rise and fall as the market rate changes. Or you could take a fixed interest rate which is 1% more than the current variable rate but which won't change as the market rate changes. Or you could take a mix of both.

How would you prefer your loan to be made up?

- 1 100% variable.
- 2 75% variable, 25% fixed.
- 3 50% variable, 50% fixed.
- 4 25% variable, 75% fixed.
- 5 100% fixed.

24. Insurance can cover a wide variety of life's major risks – theft, fire, accident, illness, death, etc. How much cover do you have?
- 1 Very little.
 - 2 Some.
 - 3 Considerable.
 - 4 Complete.
25. This questionnaire is scored on a scale of 0 to 100. When the scores are graphed they follow the familiar bell-curve of the Normal distribution shown below. The average score is 50. Two-thirds of all scores are within 10 points of the average. Only 1 in 1000 is less than 20 or more than 80.



What do you think your score will be? _____

Demographic Questionnaire

Finally, a few questions about yourself to help us understand the pattern of Risk Tolerance in our community. Please note that this section is optional and is not part of the scoring process.

1. **I am**
 - 1 Male.
 - 2 Female.

2. **My year of birth is 19_____**

3. **The highest education level I attained, or the closest equivalent, is**
 - 1 Did not complete high school.
 - 2 Completed high school.
 - 3 Trade or diploma qualification.
 - 4 University degree or higher qualification.

4. **Having in mind income from all sources - work, investment, family and government - into which income bracket does your personal before-tax income fall?**
 - 1 Under \$20,000.
 - 2 \$20,000 - \$49,999.
 - 3 \$50,000 - \$99,999.
 - 4 \$100,000 - \$199,999.
 - 5 \$200,000 - \$499,999.
 - 6 \$500,000 or over.

5. **Are you married (or in a de facto relationship)?**
 - 1 Yes.
 - 2 No.

6. **If "Yes", into which income bracket does your combined before-tax income fall?**
 - 1 Under \$20,000.
 - 2 \$20,000 - \$49,999.
 - 3 \$50,000 - \$99,999.
 - 4 \$100,000 - \$199,999.
 - 5 \$200,000 - \$499,999.
 - 6 \$500,000 or over.

7. **How many people in your family, beside yourself, do you fully or partially support financially?**

8. **Think of your net worth as being what you own, including your family home and other personal-use assets, minus what you owe. Into which bracket does the value of your net worth fall? (If you are married or have a de facto partner, include only your share of jointly owned assets less your share of what you owe jointly.)**

1 Under \$10,000.	6 \$200,000 - \$499,999.
2 \$10,000 - \$24,999.	7 \$500,000 - \$999,999.
3 \$25,000 - \$49,999.	8 \$1,000,000 - \$1,999,999.
4 \$50,000 - \$99,999.	9 \$2,000,000 - \$4,999,999.
5 \$100,000 - \$199,999.	10 \$5,000,000 or over.

You may wish to review your answers before returning the questionnaire to your advisers. In order to have your Risk Tolerance report prepared, you must answer all 25 questions in the Risk Questionnaire. Now is the best time to check for omissions and correct any mistakes.

Once your answers are recorded in the FinaMetrica system they cannot be changed. This is done to ensure the integrity of the data. If, later, you wish to change an answer, this can only be done by entering a completely new set of answers which includes the change.

INVESTMENT QUESTIONNAIRE – INDIVIDUAL

 Name, surname,
business name

Date of birth

Client's address

 Street

 Town or city

 Postal code

Client's internal number (NDG)

 (hereinafter just the "**Client**")

 Date

 Processed by

Processor's ID

UniCredit Bank Czech Republic, a.s., office at Prague 4 – Michle, Želetavská 1525/1, Postal Code 140 92, ID No.: 649 48 242, entered in the Commercial Register maintained by the Municipal Court in Prague, Section B, file 3608 (hereinafter just the "**Bank**") is obliged under the provisions of Act No. 256/2004 Coll., with its registered on Capital Market Undertakings, as subsequently amended (hereinafter just the "**Act**"), and in particular by the provisions of sections 15h and 15i of the Act, to obtain information about the Client's requisite expert knowledge and experience in investing (or, as the case may be, his or her financial background and investment objectives). The Bank does so on the basis of this Investment Questionnaire. Information requested by the Bank from the Client in this Investment Questionnaire will help the Bank proceed in the most qualified, honest and proper manner, and especially in the Client's best interest, in providing investment services and offering investment instruments.

Questions of the Investment Questionnaire

For the aforementioned reasons, the Bank hereby requests complete, precise and truthful answers to the following questions. If the Client does not fully understand any question or if he or she is not certain of its sense or formulation, the Bank will provide him or her with any necessary explanations.

QUESTION 1

Level of education, professional experience in finance

	YES	NO
Have you studied a field that deals with financial services?	<input type="checkbox"/>	<input type="checkbox"/>
Do you have longer (at least 2 years) working experience in financial services?	<input type="checkbox"/>	<input type="checkbox"/>

What types of investment services are you using or have you used?

- a) Portfolio management/assets administration/assets management
- b) Brokerage/placing orders/services of an investment intermediary
- c) Investment advisory

Note: In case of co-ownership, please provide the level of knowledge and number of operations jointly for all co-owners. In case of different values, provide the data about the co-owner with the lowest level of knowledge and/or who has carried out the least number of transactions.

QUESTION 2

Knowledge and experience in investing

Knowledge
 What do you think is the level of your knowledge with respect to the following financial instruments?
 (0 = none, 1 = low, 2 = medium, 3 = high)

Experience
 How many purchases/subscriptions have you made with the following investment instruments in the last 5 years?

Is this investment instrument currently contained in your portfolio?

For any questions not answered, the Bank will designate the answers as 0 and NO.

	0	1	2	3	0	1-3	4-6	>6	YES	NO
TYPE 1										
a) Money market funds										
b) Bonds and bond funds										
c) Structured bonds and guaranteed funds										
TYPE 2										
a) Balanced (mixed) funds										
b) Structured certificates (bonus certificates, express certificates, etc.)										
TYPE 3										
a) Shares and share funds										
b) Index certificates, ETFs										
c) Financial products issued by insurance companies (unit-linked funds)										
d) Warrants										
e) Alternative investments (hedge funds, etc.)										
f) Other funds (commodity, real estate, etc.)										

NOTES

ANALISI DELLA CONOSCENZA ED ESPERIENZA

L'analisi della Conoscenza ed Esperienza finanziaria è effettuata su ciascun soggetto intestatario/cointestatario di uno o più rapporti di investimento (nel seguito "Intestatario") nonché su ciascun soggetto tempo per tempo delegato ad operare su tali rapporti o facoltizzato ad operare in rappresentanza di una Persona Giuridica/Impresa (nel seguito "Delegato"), ciascuno di essi identificato con un proprio NSG (ciascuno, nel seguito "Cliente"). La Banca si avvale delle informazioni fornite con il presente questionario per l'individuazione del livello di Conoscenza ed Esperienza del Cliente. Tale livello sarà utilizzato per valutare la adeguatezza/appropriatezza delle operazioni per tutti i rapporti di investimento di cui il Cliente risulti - o dovesse in futuro risultare - Intestatario, o Delegato.

NSG del soggetto che rilascia le informazioni	Cognome e Nome del soggetto che rilascia le informazioni:	Rapporti intestati al Cliente	Situazione al:

Classificazione Cliente: al dettaglio

Conoscenza ed Esperienza finanziaria

Al fine di accertare, in via generale, **il grado di consapevolezza del Cliente circa la natura ed i rischi associati agli investimenti, la valutazione di adeguatezza/appropriatezza degli investimenti richiede l'acquisizione di informazioni riguardo alle conoscenze finanziarie del Cliente.**

Al riguardo, la Banca accerta le **competenze in ambito finanziario** del Cliente attraverso l'acquisizione di informazioni socio-demografiche quali il **titolo e l'ambito di studio**, il settore di **attività professionale** ed eventuali specifiche esperienze formative in materia finanziaria.

La Banca valuta le informazioni fornite su tali aspetti e, ove necessario, le integra attraverso **domande specifiche** volte a determinare il grado di conoscenza dei mercati e dei rischi connessi alle tipologie di strumenti finanziari.

L'esperienza acquisita nel corso del tempo operando su prodotti e strumenti finanziari contribuisce ad incrementare le conoscenze finanziarie del Cliente. In tal senso, la frequenza, il volume e la tipologia di **operazioni effettuate sui rapporti in essere presso la Banca sono rilevate e valorizzate automaticamente** dalle procedure della stessa.

Conseguentemente, al solo fine di valorizzare anche l'esperienza maturata presso altri intermediari, **la Banca intende acquisire informazioni sull'eventuale operatività effettuata dal Cliente in altri contesti.**

RISPOSTE AL QUESTIONARIO

Conoscenza finanziaria

In quale settore svolge, o ha precedentemente svolto, la Sua attività lavorativa? (nel caso in cui sia pensionata/o indicare il settore dell'ultima professione svolta)

Svolgo attualmente attività lavorativa nel settore Credito/Finanza/Assicurazioni

Svolgo - o ho svolto per almeno 1 anno - una professione di natura finanziaria, ovvero di amministrazione e controllo, ovvero un'attività direttiva presso un'impresa in una posizione lavorativa che presupponga la conoscenza degli strumenti finanziari e dei servizi di investimento

Altro

E' Sua abitudine monitorare attraverso quotidiani o siti internet l'andamento dei mercati finanziari?

No

Saltuariamente

Regolarmente

Qual è il Suo titolo di studio?

Licenza elementare

Licenza media inferiore

Licenza media superiore

Laurea

Qual è stato l'indirizzo dei Suoi studi?

Lauree/Master ad indirizzo Economico e Giuridico

Lauree ad indirizzo Scientifico (ad es: Matematica, Statistica, Ingegneria, Fisica, Medicina ...)

Lauree ad indirizzo Umanistico (ad es. Lettere, Filosofia, Storia, ...)

Conosce la relazione esistente tra il rischio e il rendimento degli investimenti? In particolare, è a conoscenza del fatto che il rendimento degli investimenti è, di norma, tanto più elevato quanto è maggiore il rischio ad essi associato?

Si

No

E' a conoscenza del fatto che l'investimento dell'intero capitale disponibile in un singolo prodotto finanziario espone l'investitore ad un rischio maggiore rispetto all'investimento del medesimo capitale in un portafoglio diversificato di prodotti e strumenti finanziari?

Si

No

Conosce la differenza tra azioni e obbligazioni? In particolare, è a conoscenza del fatto che l'investimento in azioni è, di norma, soggetto ad un rischio maggiore (inteso come variazione di valore) rispetto all'investimento in obbligazioni?

Si

No

E' a conoscenza che i prodotti finanziari in valuta diversa dall'Euro (ad es. Obbligazioni in Dollari e Sterline) presentano un rischio (cd. rischio di cambio) derivante dalle oscillazioni di valore nel tempo della valuta estera rispetto all'Euro?

Si

No

E' a conoscenza del fatto che un prodotto finanziario è liquido quando può essere venduto rapidamente e senza differenze significative di prezzo rispetto al suo valore di mercato?

Si

No

Esperienza finanziaria

Le domande che seguono sono da riscontrare solamente qualora Lei abbia effettuato operazioni di investimento presso altri intermediari. Intende rispondere?

Si

No

Quante operazioni aventi ad oggetto prodotti finanziari (es. azioni, obbligazioni, titoli di stato, fondi comuni di investimento, prodotti finanziari-assicurativi, certificates, derivati) ha effettuato con altri intermediari finanziari negli ultimi 12 mesi?

Fino a 5

Oltre 5 - fino a 20

Oltre 20

Per quale controvalore complessivo?

Fino a 5.000 euro

Oltre 5.000 euro - fino a 20.000 euro

Oltre 20.000 euro - fino a 50.000 euro

Oltre 50.000 euro

Sempre con riferimento alle operazioni effettuate presso altri intermediari, in quale dei seguenti prodotti finanziari ha investito negli ultimi 2 anni?

Conti deposito/Buoni Postali

Certificati di deposito

Titoli di stato

Obbligazioni

Gestioni Patrimoniali

Fondi comuni di investimento/ETF

Prodotti finanziari-assicurativi

Azioni

Obbligazioni strutturate

Certificates

Derivati

IDENTIFICAZIONE DEL LIVELLO DI CONOSCENZA ED ESPERIENZA

Gentile Cliente,

il livello di Conoscenza ed Esperienza, accertato con la sottostante valutazione sintetica, viene utilizzato su tutti i rapporti di cui Lei risulti - o dovesse in futuro risultare - Intestatario o Delegato.

In base alle risposte fornite, la Banca Le attribuisce il seguente livello di Conoscenza ed Esperienza, che utilizzerà per effettuare la valutazione di adeguatezza/appropriatezza delle operazioni in prodotti finanziari da Lei disposte su tutti i rapporti di investimento dei quali Lei risulti Intestatario o Delegato.

OMISSIS

Il Cliente dichiara di essere stato informato che, a valere sui rapporti di investimento per i quali non intenda usufruire del servizio di consulenza, le operazioni di investimento e disinvestimento potranno essere effettuate, avvalendosi della sola valutazione di appropriatezza, esclusivamente attraverso i Servizi via Internet, Cellulare e Telefono con le modalità e nei limiti previsti nel relativo contratto.

Le variazioni delle informazioni sopra indicate, da cui possa derivare una modifica del livello di Conoscenza ed Esperienza, devono essere comunicate alla Banca tempestivamente.

Il Cliente dichiara di aver ricevuto un esemplare del presente documento.

Luogo e data

Se questo documento è sottoscritto dal Cliente con Firma Grafometrica, esso è sottoscritto dalla Banca con firma digitale. Tuttavia se il Cliente chiede che il documento gli sia consegnato in formato cartaceo, l'esemplare del documento consegnato è sottoscritto dalla Banca con firma autografa.

NOME E COGNOME

(FIRMATO CON FIRMA ELETTRONICA AVANZATA)

Firma

NOME E COGNOME

(FIRMATO CON FIRMA ELETTRONICA AVANZATA)

NOME E COGNOME

(FIRMATO CON FIRMA ELETTRONICA AVANZATA)

L'operatore:

(denominazione Banca)