

RETAIL INVESTORS AND THE DIGITALISATION OF FINANCIAL MARKETS

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BACKGROUND: THE RETAIL INVESTMENT STRATEGY

- **First CMU Action Plan** launched in 2015: goals to improve integration among European capital markets
- **Mid-Term Review** conducted in 2017: measures to strengthen the CMU programme
- **New Action Plan** launched in September 2020: implementation of the Retail Investment Strategy (RIS)
- The **RIS** sets out cross-sectoral initiatives aimed at enhancing investors' protection, fair treatment and participation in capital markets, with a direct focus on retail investors
- **ESMA's technical advice** on the RIS published on 29 April 2022:
 - support higher standardisation of information subject to disclosure requirements
 - adopt stricter guidelines on marketing communications and protection from aggressive communications
 - avoid information overload
 - align costs and charges disclosures between PRIIPs and other disclosure documents
 - address potentially damaging practices (such as payment for order flows (PFOF))
- On 24 May 2023, the European Commission published the comprehensive **Retail Investment Package**, comprising
 - A Directive amending rules set out in MiFID II, IDD, UCITS Directive, AIFMD, and Solvency II ("**Omnibus Directive Proposal**")
 - A **Regulation amending the PRIIPs Regulation**, in particular with regard to rules on the KID

BACKGROUND: DIGITALISATION OF EUROPEAN FINANCIAL MARKETS

- The last decade has witnessed a **sharp rise in the popularity of new generation retail investment distributors**, such as online discount brokers and social trading platforms
- As digitalisation progresses and smartphone penetration increases, **younger retail investors especially are moving away from traditional retail investment distributors**, instead choosing online discount brokers and social trading platforms for their investments
- **Commission-free trading apps and the introduction of fractional share trading** have also been important factors for bringing new retail investors to capital markets
- **In the EU**, according to the Report "Disclosure, inducements, and suitability rules for retail investors" issued by Kantar Public in cooperation with Milieu and the Centre for European Public Studies (CEPS):
*"Some **14% of respondents stated that they had received digital advice**. (...) The share of consumers using digital sources to select product is particularly high in Poland (22%) and Romania (19%) while it is low in Italy (7%)"*
- Digitalisation can impact retail investors in different ways, from the **automation of transactions through online platforms**, to **robo-advice** and **new types of financial products and services** offered in the digital context, such as **crypto-assets**

DIGITALISATION: PROS AND CONS

PROS

- Increase in **speed and efficiency** of services provided
- Reduction in **costs**
- **Wider access** to financial services and products
- Emergence of **new players**
- More **direct participation** by retail clients (shareholder activism?)

CONS

- **Operational risks**
- **Cybersecurity risks**
- **Gamification**
- Retail investors **may not understand the risks** arising from digitalisation:
 - The **role of machines vis-à-vis human component** (robo-advice)
 - Use of **digital interfaces used for taking investment decisions** (such as trading platforms)
 - **Interaction between the machine and the human** in an automated communication system (chats)

GAMIFICATION OF CAPITAL MARKETS

- In essence, **gamification is the practice of infusing game-like elements into non-game contexts to encourage engagement** with a product or service
- It is a **technique** that has been employed in a variety of settings and is **now being adopted in financial markets**
- ESMA's final report on retail investor protection discusses the risks and benefits of gamification techniques:
 - On the one hand, they offer the **potential of simplifying investment processes**, thereby **expanding the access to financial products** and **fostering engagement**
 - On the other, **gamification can unduly influence the behaviour of inexperienced investors**
- Specifically, gamification:
 - **may nudge investors towards the adoption of more aggressive investment choices,**
 - **may induce trading in complex or high-risk products by inexperienced investors, and**
 - **may encourage harmful behaviours**

DIGITALISATION AND SHAREHOLDER ACTIVITISM

- **Retail investors have opened millions of new brokerage accounts:** according to estimates, as many as 17 million in 2020 and over 20 million in 2021
- The **new generations of retail investors invest primarily using app native trading platforms and source investing information largely via social media** (v. Gamestop case)
- For some, through voting, these new generations of retail investors can **shift the current corporate governance paradigm**, providing **greater representation and diversity** across boards
- According to parts of the existing literature, new retail investors investing through digital channels could also help:
 - bridging the gap between business corporations and society
 - fostering long-term investments
 - increasing shareholder engagement
 - fomenting ESG goals
- ❖ **However, is there a necessary correlation between digitalisation and shareholder activism?**

PROPOSALS: THE DIGITAL SUITABILITY TEST

- As a way to directly enhance the level of protection of retail investors in the digital context, we propose the introduction of a new **‘digital suitability test’**
- The test **would apply before retail investors have access to digital services and platforms** (especially in gamified environments)
- Moreover, the test **would aim at assessing the knowledge and awareness that the investor has in relation to the financial digital context, its basic instruments and dynamics**
- Users failing to pass such an assessment would either
 - receive a **pop-up warning discouraging them to access certain categories of products**; or
 - be **prohibited from concluding the transaction**
- They would then receive a **recommendation to seek forms of investment advice better suited for them**
- Indications should be made in **plain-language messages that are easily understood**

PROPOSALS: REFORM OF THE NOTION OF 'INVESTMENT ADVICE'

- A practice that has been developing recently and that requires more attention is the **onboarding of clients through social media channels** or **providing recommendations through unregulated entities**
- The **rising cases of digital influencers openly advertising financial products in social media or recommending certain products or strategies in posts and chats** (either collectively or individually) also calls for attention
- In the digital context, **the issue is related to the notion of 'investment advice' provided under MiFID II**, which is currently too narrowly defined
- **Reforms to the definition of 'investment advice' and further initiatives should therefore be considered** to capture these new phenomena and the risk they pose to retail investors in digital environments
- ❖ For example, on June 1, 2023, the French Parliament adopted a bill to regulate social media influencers' activities in a bid to curb the promotion of dangerous products and trends. The law (*L. n° 2023-451, 9 juin 2023, visant à encadrer l'influence commerciale et à lutter contre les dérives des influenceurs sur les réseaux sociaux*) **also contains provisions regulating influencers of capital markets**: see art. 14 '*Promotion d'offres d'investissement en ligne*'

- ❖ Under MiFID II, investment advice is characterised by two core elements:
 - (i) The **personalised nature** of the recommendation or advice; and
 - (ii) The **specificity of the transaction** to which the advice refers

In the absence of both these elements, the service falls out of the scope of the definition of 'investment advice under MiFID' and risks being unregulated

PROPOSALS: FOSTERING FINANCIAL EDUCATION

- The Omnibus Directive Proposal put forward by the Commission **embraces the objective of promoting financial literacy**. New provisions are to be included by means of amendments to the MiFID II and the IDD.
- In short, **the proposed articles establish dedicated provisions on “financial education” and set forth a generic obligation for Member States to promote financial education measures at national level**, so that
 - (i) in the case of MiFID, existing and prospective retail investors are able to invest responsibly when accessing investment services or ancillary services; and
 - (ii) in the case of the IDD, responsible purchase of insurance products when accessing insurance services or ancillary services is fostered.
- The **initiative moves in the right direction** and **will require further efforts in the definition of the exact policies to be implemented**
- Nonetheless, it would be also advisable to envisage a **Union-wide initiative supported by a dedicated budget**

GRAZIE!

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