

# RETAIL INVESTORS AND THE DIGITALISATION OF FINANCIAL MARKETS

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2023



# 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 unexperienced investors**
- Specifically, gamification:
  - **may nudge investors towards the adoption of more aggressive investment choices**,
  - may **induce trading in complex or high-risk products by unexperienced 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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