Misselling in Self-placement and Bank Resolution under BRRD2

by

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1. Bank crises and the treatment of retail investors in the BRRD era. – 2. The problem of misselling in the context of self-placement of securities issued by banks. – 3. The (loose) interplay between investor protection and bank resolution in the current regulatory environment. – 4. The Single Resolution Board's policy on the treatment of retail clients' holdings for the purpose of MREL eligibility. – 5. Art. 44a BRRD 2 on the «selling of subordinated eligible liabilities to retail clients». – 6. The need for a more effective integration between investor protection and bank resolution discipline: from an ex-post to an ex-ante approach. The role of product governance under MiFID 2. – 7. Concluding remarks.

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1. Bank Crises and the Treatment of Retail Investors in the BRRD Era

1.1. Looking at how bank insolvencies have been managed throughout Europe since the EU's choice in favour of bail-in[1], what emerges as striking – strongly differentiating the current situation from the past – is the significant allocation of the burden of banking crises upon unsophisticated investors.

To some extent, the involvement of retail investors in the «internal» recapitalization of insolvent banks is a natural consequence entailed by the envisaging, at the EU level, of a stricter view of the legitimacy of State assistance to the banking sector. Provided that the new framework calls for the application of burden-sharing and bail-in without distinguishing between professional and retail investors, the actual degree of involvement of the latter in the cost of resolution depends on the distribution of bail-inable bank-issued securities among that category of investors: the higher the percentage of instruments held by retail clients, the higher the losses to be allocated to them in case of a bank's resolution. This is influenced by the structure of the financial services markets throughout Europe or, better said, by the existence of a habit or tradition of households directly (i.e. not through a collective investment scheme) investing in bank-issued securities. In fact, it appears that in some EU countries the banking industry relies upon this financing channel (placement of self-issued securities to retail investors) more than others[2].

1 On the EU resolution regime in general terms see, among others, *Gianni Lo Schiavo,* "State aids and credit institutions in Europe: what way forward?", European Business Law Review, 2014, p. 427–457; *Dalvinder Singh*, Recovery and Resolution Planning: Reconfiguring Financial Regulation and Supervision, in: Jens H. Binder/Dalvinder Singh (ed.), Bank Resolution: The European Regime, 2016; *Christos Hadjiemmanuil*, "Limits on State-Funded Bailouts in the EU Bank Resolution Regime", EBI Working Paper Series, 2017 – no. 2; *Pierre de Gioia Carabellese/Daoning Zhang*, "Bail-in Tool and Bank Insolvency: Theoretical and Empirical Discourses around a New Legal (or Illegal) Concept", European Business Law Review 30, no. 3 (2019), p. 487–512.
On the bail-in, as opposed to bail-out, mechanism in general, see, among others, *Marco Ventoruzzo/Giulio Sandrelli,* "O Tell Me The Truth About Bail-In: Theory and Practice", ECGI Working Paper Series in Law, Paper N° 442/2019, March 2019, *Charles Goodhart/Emilios Avgouleas,* "A Critical Evaluation of Bail-ins as Bank Recapitalisation Mechanisms", in Centre for Economic Policy Research Discussion Paper 10065, July 2014; *Andreas Dombret,* Solving the Too-Big-To-Fail-Problem for Financial Institutions, in: Patrick S. Kenadjian (ed.), The Bank Recovery and Resolution Directive Europe's Solution for "Too Big To Fail"?, Berlin, 2013.

2 With specific reference to debt securities, the extent of reliance on these investors can be seen from a data analysis published by the ECB and the ESRB (referring to Q3 2017) showing that retail investors continue to hold an important share of EU debt securities issued by European banks. The level of retail participation varies throughout Europe – by nominal amount, a high concentration is evident in a few countries: Italy has the largest

Such a circumstance doesn't constitute a *per se* dysfunctional feature of the resolution framework. However, imposing losses on retail investors in the context of a bank's insolvency cannot be seen as a natural outgrowth of the new rules on banks' crises, if the self-placement of those securities was carried out in breach of conduct rules governing investment services under the provisions of EU law (now, MiFID II and the implementing acts thereof).

1.2. In this regard, a fundamental distinction must be drawn between the case of isolated breach of conduct rules and that of extensive or serial misselling of self-issued securities, whereby by «extensive» and «serial» we refer to a situation in which misselling occurred in a significant number of cases relating to the same offer, service or product, thereby suggesting the inability of the firm to put in place, *at a general level*, policies and procedures sufficient to comply with the framework of investor protection rules (Article 16 MiFID 2). As a matter of fact, misselling often has a *serial character*, as it is a consequence of how the distribution strategy is conceived and implemented by the bank's top management (in terms of goals required to the distribution network, inducements' structure, identified market target, etc.). When a serial misselling occurs, the distribution strategy could be either conceived in willful breach of the general duty of care and to act in the client's best interest, or just poorly implemented (that is, the intermediary is unable to ensure that its own interest in achieving its financing and commercial objectives does not prevail on the duty to protect the interest of its clients).

Indeed, while the case of isolated breaches points to the enforcement of conduct rules in investment services without any interference with the application of the resolution framework, the occurrence of serial misselling is actually capable of affecting the effective implementation of the resolution action itself, and may even render it impracticable: i.e., compliant with all *the principles and objectives assigned to resolution*[3] and *the mandatory substantive pro-*

amount (EUR 132.3 bn) followed by Germany (EUR 49.4 bn) and then France (EUR 31.7bn). The distribution of retail debt is quite fragmented, with much smaller nominal amounts reported after the first five countries shown (i.e. Italy, Germany, France, Austria and the UK). Measured as a proportion of banks' total debt (36.9%) and as a proportion of total banking sector assets (3.4%), banks in Italy have the largest proportion of Euro area retail holders. It is worth noting that in the Italian market, nearly all bondholders are Italian, while in other countries the distribution market is wider, extending beyond national borders.

3 As set out See the resolution objectives set out in Article 31 Directive (EU) 2014/59 on Bank Recovery and Resolution (BRRD), according to which the «resolution objectives» are «*(a) to ensure the continuity of critical functions; (b) to avoid a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline; (c) to protect public funds by minimising reliance on extraordinary public financial support; (d) to protect depositors covered*

visions[4] set out in the relevant pieces of legislation (BRRD, SRMR and the delegated acts thereof).

More specifically, the risk of massive misselling hampering the resolution's feasibility involves three different layers, each of which raises serious challenges to the conceptual and normative framework underpinning resolution.

1.2.1. First of all, holders of securities purchased in breach of MiFID rules suffer, in case of the issuer's default, the effect of a risk that they did not assume «correctly», *i.e.* in a way that can be considered compliant with the rules applicable to the investment services provided when the financial instrument was negotiated.

Obviously, this is in apparent contrast with one of the rationales underpinning the 2013 Banking Communication (and subsequently the BRRD); that is, to conceive bail-in as a means of preventing moral hazard by investors (which, in contrast, is promoted by the common expectation of a bail-out), thus ensuring market discipline with reference to bank-issued securities. It is clear, however, that when a large-scale practice of misselling in self-placement occurs, the idea of making the victim of misselling contribute to the loss cannot have any deterrent effect on moral hazard; all the investment decisions put in place by such investors were flawed *by definition*.

1.2.2. Moreover, investors belonging to the category of «retail clients»[5] are highly exposed to the risk of lacking the financial ability to bear the losses im-

by Directive 2014/49/EU and investors covered by Directive 97/9/EC; (e) to protect client funds and client assets. When pursuing the above objectives, the resolution authority shall seek to minimise the cost of resolution and avoid destruction of value unless necessary to achieve the resolution objectives».

The notion of resolvability is laid down in Article 15(2) Directive (EU) 2019/879 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC (BRRD2), according to which «an institution shall be deemed to be resolvable if it is feasible and credible for the resolution authority to either liquidate it under normal insolvency proceedings or to resolve it by applying the different resolution tools and powers to the institution while avoiding to the maximum extent possible any significant adverse effect on the financial system, including in circumstances of broader financial instability or system-wide events».

4 In particular, the no-creditor-worse-off principle set out in Article 74 BRDD. This aspect will be deepened in the following subsection n. 1.2.3.

5 Under Directive (EU) 2014/65 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (MiFID 2), a retail client means a client who is not a professional client, whereas professional client means a client meeting the criteria laid down in Annex II, that is: (i) entities that are required to be authorised or regulated to operate in the financial markets; (ii) entities that are engaged in large undertakings; (iii) national and regional governments, including public bodies that manage public debt at a

posed by the conversion and/or writing-down of the securities they purchased. Of course, the ability of the client to bear losses decreases as the percentage of the bailed-in securities on the client's total assets increases; in other words, the problem is more acute when misselling also results in an excessive concentration of the client's assets in those same securities.

Such a situation might be counterproductive with reference to another main goal of the resolution framework, which is ensuring financial stability[6], *sub specie* of avoiding contagion and preserving market confidence. Indeed, the interaction between the breach of conduct of business rules in investment services and financial stability is now borne in mind also by MiFID 2, whose recital 5 states that «*incorrect conduct of firms providing services to clients may lead to investor detriment and loss of investor confidence*».

Potentially, the investors' loss of confidence might affect not only the macro level of financial stability, but also the viability of the resolution of the failed credit institution, where the misselling actually occurred. This happens, in particular, when the unjustly harmed investors are, at the same time, the bank's clients by virtue of other deposit, lending or investment contractual relationships. In such a situation, the bail-in of instruments held by retail clients could prompt a significant number of individuals to react by withdrawing deposits or, more generally, exiting the bank as clients, thus reducing the post-resolution customer base.

1.2.3. Finally and even more importantly, extensive misselling makes it nearly impossible to ascertain in a timely way the *real* total amount of liabilities weighing on the failing credit institution[7].

national or regional level, central banks, international and supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations; and (iv) other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions.
Investors who do not fall into any of these categories can «be allowed to waive some of the protections afforded by the conduct of business rules» when specific circumstances and procedures are met (see Annex II.II of MiFID 2). For the purposes of the present essay, we consider a retail client to be any investor who is protected by any conduct of business rule set out in MiFID 2 whose breach could be sanctioned.

6 See, in addition to the EU Commission's 2013 banking communication, the «Key Attributes of Effective Resolution Regimes for Financial Institutions» by the Financial Stability Board (2016 version): «*The objective of an effective resolution regime is to make feasible the resolution of financial institutions without severe systemic disruption*».

7 Working as a potential cause for impediment to carry out the resolution action in a reasonable time, which is one of the cases under which the Resolution Authority can discretionarily exclude some liabilities from bail-in under Article 44. On this topic, see above, no. 4.3.

In order to better illustrate this statement, it is necessary to proceed from the obvious assumption that, when placing self-issued securities, the bank plays both the role of issuer and that of an investment service provider. On the level of private enforcement[8], this means that the default of the issuer – and the subsequent writing down, conversion or bail-in of one or more classes of securities – would entitle unjustly harmed investors (provided they were victim of misselling) with a private-law remedy (in the form of compensation or restitution, according to the National legislation) against the selling bank, in its capacity as investment service provider[9].

This circumstance does not interfere with the resolution feasibility when misselling is limited in size (that is, when it is not extensive or serial) and, accordingly, the impact of the liabilities thereof on the bank's total assets is negligible. However, if serial or massive misselling of self-issued securities does take place, quantity becomes quality: the total amount of claims by damaged investors may be so relevant so as to affect in a significant way the liability side of the bank's balance sheet[10].

In fact, the performance of an accurate assessment of the bank's liabilities by the Resolution Authority plays a pivotal role in the resolution's feasibility, given the absence of a judicial ascertainment of the bank's liabilities, as is the in "ordinary" insolvency procedures[11].

Accordingly, BRRD expressly and formally compels the bank to perform a valuation of these liabilities before taking any resolution action or exercising write-

8 This is true insofar as internal law entitles an investor affected by the breach of conduct of business rules with some kind of private law remedy (generally, in the form of compensation or restitution). On the issue of the mandatory nature of the private enforceability of MiFID conduct rules in the light of the ECJ's case law (especially, the so called Genil case), see the statement by *Evariest Callens,* "Recalibrating the Debate on MIFID'S Private Enforceability: Why the EU Charter of Fundamental Rights is the Elephant in the Room", European Banking Institute Working Paper Series 2019 – no. 38, which deserves full support. In the same terms, see also the extensive analysis carried out by *Federico Della Negra*, MiFID II and Private Law, 2019, especially at pages 177 et seq. On this topic, see also *Danny Busch*, "The Private Law Effect of MiFID: the Genil Case and Beyond", in: Danny Busch/Guido Ferrarini (ed.) Regulation of the EU Financial Markets. MiFID II and MiFIR, 2017, 567.

9 The bank's liability could also derive from having redacted the offering prospectus (in case of a public offering of securities), or even from having disclosed false information to the market through its financial statements or by other means.

10 On the treatment of disputed claims within resolution, see *Jens-Hinrich Binder,* Bank Bail-in and Disputed Claims: "Can it Cope? The case for and against a vis attractiva resolutionis", EBI Working Paper Series 2019 – no. 32.

11 On the functional parallels and structural differences between insolvency and liquidation, see *Binder,* (fn. 10) p. 10.

down or conversion powers. The Directive requires it to be «*fair, prudent and realistic*» and carried out by a person «*independent from any public authority, including the resolution authority, and the institution*» [Article 36(1) BRRD2]. This serves the purpose of informing both «*the determination of whether the conditions for resolution or the conditions for the write down or conversion of capital instruments and eligible liabilities ... are met*» [so called «valuation 1»: Article 36(4)(a)] and «*the decision on the appropriate resolution action to be taken*».

More broadly, any decision taken by the Resolution Authority revolves around the valuation of the failing bank's assets and liabilities; more specifically, all decisions about the «*extent of the cancellation or dilution of shares or other instruments of ownership, and the extent of the write down or conversion of relevant capital instruments and eligible liabilities*», about «*the extent of the write down or conversion of bail-inable liabilities*», about «*the assets, rights, liabilities or shares or other instruments of ownership to be transferred and the decision on the value of any consideration to be paid to the institution under resolution or, as the case may be, to the owners of the shares or other instruments of ownership*» in the context of the application of the tools of bridge institutions or asset separation, and about «*the assets, rights, liabilities or shares or other instruments of ownership to be transferred*» in the case of a sale of assets. Last but not least, the evaluation also serves the purpose of ensuring «*that any losses on the assets of the [failing] institution are fully recognised at the moment the resolution tools are applied or the power to write down or convert relevant capital instruments and eligible liabilities ... is exercised*» [Article 36(4)(b)(c)(d)(e)(f)(g): all together, so called «valuation 2»].

Deeply influenced by claims arising from misselling practices is also the so-called «valuation 3», whose purpose is «*assessing whether shareholders and creditors would have received better treatment if the institution under resolution had entered into normal insolvency proceedings*» (Article 74 BRRD) in line with the "no-creditor-worse-off" principle, which is the milestone of creditors' protection in resolution.

Neither can liabilities stemming from misselling be ignored in the context of resolution, simply because they were not previously ascertained by a court through a decision that has already formed *res iudicata* (at the very moment when the resolution action is taken).

Regardless of the fact that the existence of a causal link between the misselling and the loss often does not emerge until instruments are written down or converted by the Resolution Authority[12], the current framework is crystal clear in

12 When the credit institution's insolvency approaches, budget amendments could be necessary as the consequence of the carrying out of a «fair, prudent and realistic valuation

stating that the contingent nature of a liability does not exclude the need of taking it into consideration for all relevant purposes[13], starting from the determination of the bank's shortfall and subsequent needs for financing. In practical, this means that the Resolution Authority needs to have, *all along the three valuation*s, an accurate understanding of all liabilities, including the ones stemming from misselling in self-placing, regardless of whether or not (and how) they has already been reported in the bank's financial statements according to accounting standards. In fact, while some investors may have sued and already obtained a final ruling in their favor, for some others the trial may be still in progress; still others may have only filed a complaint (but not sued yet) or even not taken any action in this respect[14]. Still, none of their claims can be ignored in the resolution process: the Resolution Authority is bound to the assessment of all the existing bank's liabilities, and cannot just rely on what the bank's statement reports[15].

of the assets and liabilities of the institution» that is required before a resolution action is taken action or the power to write down or convert capital instruments [Articles 36 and 59(10) BRRD].

13 According to recital 3 of Commission Delegated Regulation (EU) 2018/345 on valuation before resolution, «*the valuer should have access to any sources of relevant information and expertise, such as the internal records, systems, and models of the institution. … The resolution authority should … be satisfied that the valuer has access to either a list of all claims including contingent claims held against the entity and classified according to their rights and priority under normal insolvency proceedings, or to adequate legal expertise for the preparation of such list*». Similarly, recital 4 of Delegated Regulation 2018/344 (on valuation after resolution) states that «*In order to ensure that a comprehensive and credible valuation is carried out, the valuer should have access to any appropriate legal documentation, including to a list of all claims and contingent claims against the entity, classified according to their priority under normal insolvency proceedings. The valuer should be allowed to enter into arrangements to obtain specialist advice or expertise as required by the circumstances*».

14 Which could be the case when the damage arising from the misselling emerges as a direct consequence of the exercise of a resolution power (for instance, when false information about the financial situation of the issuer were provided when placing the instruments which were eventually subject to bail-in).

15 Even if we leave aside the hypothesis of balance sheet misreprentations, it is clear that accounting reporting rules of contingent liabilities are conceived for different purposes than the one of fair treatment (i.e., compliance with the no-creditor-worse-off principle) of liabilities in a resolution or liquidation procedure. The need for a different kind of assessment to be carried out by the Resolution Authority is clearly expressed in the resolution framework: besides Article 74 BRRD, which calls for a comparison between the treatment of creditor in the resolution and the one that would have taken place in «normal insolvency proceedings», see Delegated Regulation 344 and 345 2018 quoted at fn. 13.

Actually, the need for the Resolution Authority to have a comprehensive understanding of contingent liabilities (also) stemming from the breach of conduct rules is something that can be referred to any kind of misselling as the realization of a conduct risk[16], also beyond the case of self-placement. Nevertheless, it is submitted that, in the context of bank resolution, misselling in placing self-issued instruments is utterly insidious, insofar not only it creates a new set of liabilities, but it also – and by direct consequences of the misselling occurring – hampers the institution's loss-absorption capacity (because own funds and eligibile liabilities placed in breach of protection investor rules will hardly be able to absorb losses other than compensation/restitution claims due to the misselling itself: see just above, no. 1.3, last paragraph), thus having an amplifying effect on the credit institution crisis. Moreover, this kind of misselling can reach enormous dimensions, especially in countries where the retail clientele is used to purchasing and holding these securities.

On the basis of the above, it is clear that the existence of serial or extensive misselling practices with respect to self-issued securities makes it extremely costly and time-consuming for the Resolution Authorities to take fully informed decisions and, consequently, to perform a resolution that is effective and compliant with the current regulatory framework, starting from the no-creditor-worse-off principle. Ultimately, the overall «quality» (in terms of compliance with the investor protection framework) of a bank's self-placement process is something that one would want to fully understand before deciding how to address a bank's crisis.

1.3. The uncertainty provoked by the existence of an unknown burden on the bank's balance sheet resulting from serial or even massive misselling of self-issued securities also has an impact on the *ex-ante* side of the resolution authority's activity[17]. Namely, it prevents an accurate assessment of the actual loss-

16 See *Antonella Sciarrone Alibrandi/Claudio Frigeni*, "Managing Conduct Risk: From Rules to Culture", in: Danny Busch/Guido Ferrarini/Gerard Van Solinge (ed.), Governance of Financial Institutions, 2019, p. 468–488, which focus on the relationship between conduct of business rules and prudential supervision.

17 See Art. 10(2) BRRD2: «When drawing up the resolution plan, the resolution authority shall identify any material impediments to resolvability and, where necessary and proportionate, outline relevant actions for how those impediments could be addressed, according to Chapter II of this Title [i.e., Articles 15 ff. thereof]».
The definition of resolvability is laid down in Article 15(2) BRRD2. From a more operational standpoint, the idea of the «feasibility» and «credibility» of the resolution is clarified by Section C of the same Directive («*matter that the resolution authority is to consider when assessing the resolvability of an institution or group*»), which expressly requires consideration of, inter alia, «*the amount and type of bail-inable liabilities of the institution*», as well as «*the extent to which the impact of the institution's resolution on the financial system and on financial market's confidence can be adequately evaluated*»

absorption capacity of the credit institution, with special reference to the writing down or bail-in of the class of securities involved in the misselling.

This is entailed by the existence of a close relationship between, on the one hand, the massive breach of conduct of business rules, and, on the other hand, the *actual* loss-absorption capacity of the credit institution.

This relationship can be presented as follows. The orderly planning of resolution actions to be taken when the bank reaches the point of non-viability requires that the resources to finance resolution are previously identified («peace-time» planning).

As is well-known, within the resolution framework this goal is fulfilled by requiring the credit institution to meet a ratio of own funds and «eligible liabilities» (that is, items as defined in chapter 5a, Section I of CRR2; Articles 72a ff.) compared to the total risk exposure amount[18]. Ultimately, this requirement – whose level is calibrated on an individual basis by the Resolution Authority – is meant to ensure that the credit institution always maintains a sufficient loss-absorption capacity[19].

However, even from this standpoint, the existence of serial or massive misselling risks undermining the entire mechanism. In fact, as suggested just above, when MREL securities held by retail clients are placed in violation of conduct rules, their use as a means of loss absorption is, at the very least, truly problematic: their bail-in would simultaneously satisfy the internal financing need (by absorbing losses for the corresponding amount), and create a new set of liabilities (that is, compensation and/or restitution claims arising from the misselling[20]). Ultimately, since – as we believe – the amount of the latter must also be assessed and taken into account when deciding the resolution actions to be implemented, the end result is a vicious circle between internal recapitalization and fair treatment of the bank's liabilities.

and «*the extent to which the resolution of the institution could have a significant direct or indirect adverse effect on the financial system, market confidence or the economy*».

18 Minimum requirements for own funds and eligible liabilities (MREL): Chapter, 4, Section 5, Subsection II of BRRD; Articles 45 ff.

19 On this topic, see the insights by *Peter Brierley*, "Ending Too-Big-To-Fail: Progress Since the Crisis, the Importance of Loss-Absorbing Capacity and the UK Approach to Resolution", in European Business Organization Law Rev, 2017, 18, 457–477.

20 It is importantly noted that those liabilities would rank *pari passu* with all the senior debt, regardless of the instrument's level of subordination.

2. The Problem of Misselling in the Context of Self-placement of Securities Issued by Banks

2.1. The problem introduced above is not merely theoretical. Actually, at least with reference to self-placement of bank-issued securities, the deterrence of the MiFID framework (as applied at the national level) has proven to be quite low[21]. Indeed, that framework was essentially unable to prevent – or manage in a timely way – several episodes of serial or massive misselling, quite significant both in amount and temporal extension.

In recent years, the nature and extent of this weakness of the regulatory environment has been investigated by scholars, with specific reference to self-placement of bank issued-securities, in the wake of numerous cases of widespread misselling that occurred across the EU[22].

Indeed, there is a strong consensus about the fact that the current relevance of the problem – which is indeed historical, at least in National markets that rely on banks' client bases as a major channel of financing – is triggered by two concurrent factors, which lend a whole new dimension to the relationship between the issuing bank and the client-investor.

21 For a comprehensive overview of misselling from a general (i.e. not limited to bank-issued securities) perspective, see *Alexander Kern,* "Mis-selling of Financial Products: Marketing, Sale and Distribution", Study requested by the ECON Committee of the European Parliament, June 2018, available at http://www.europarl.europa.eu/studies.

22 See *Pierre Henri Conac,* "Mis-selling of Financial Products: Subordinated Debt and Self-placement", Study requested by the ECON Committee of the European Parliament, June 2018, available at http://www.europarl.europa.eu/studies, according to whom «*the issue of mis-selling of shares and subordinated debt by financial institutions to retail investors is, without a doubt, the most serious regulatory and enforcement failure in the area of investor protection in the EU since the 2008 crisis*»; *Pierre Henri Conac,* "L'auto-placement d'instruments financiers par les établissements bancaires et la protection des investisseurs par l'European Securities and Markets Authority (ESMA)", in: Jean-Pierre Buyle/Frédérique Ferrand (ed.), Liber Amicorum Blanche Soussi, 2016, 369; *Lorenzo Stanghellini,* "Tutela dell'impresa bancaria e tutela dei risparmiatori", *Banca, Impresa e Società*, 2018, n. 3, 421; *Simone Alvaro/Marco Lamandini/David Ramos Muñoz/Elena Ghibellini/-Francesca Pellegrini,* "The marketing of MREL securities after BRRD. Interactions between prudential and transparency requirements and the challenges which lie ahead", Consob Legal Research Papers, 15, December 2017; *Günter Franke*, "Thomas Mosk and Eberhard Schnebel, Fair Retail Banking: How to Prevent Mis-selling by Banks", SAFE White Paper No. 39, July 2016; *Martin R. Götz, Tobias H. Tröger,* "Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?", Paper requested by the European Parliament's Economic and Monetary Affairs Committee, March 2016, available at http://www.europarl.europa.eu/RegData/etudes/IDAN/2016/497723/IPOL_IDA(2016)497723_EN.pdf.

The first gamechanger is represented by the adoption of the resolution framework itself. More specifically, the principle according to which – in the context of a resolution action – public finance can only intervene under very narrow circumstances [Art. 37(10) BRRD] makes it possible that investors suffer an actual prejudice from misselling in case the issuer becomes insolvent, whereas before the burden-sharing era debtholders (and sometimes also shareholders[23]) would be kept safe from losses due to the issuer's insolvency as the consequences of State-funded bail-outs. Such traditional behaviour had led the market for bank-issued securities to fall short of price efficiency and market discipline, without it being directly relevant to investors, as far as the risk of losing the invested capital was concerned.

The second gamechanger must be identified in the new and more stringent capital requirements introduced after the financial crisis (as part of Basel III and, with specific reference to the EU, CRD IV and CRR). Since, nowadays, capital thresholds are more rigorous and therefore more difficult to comply with, the conflicts of interest, inherently characterizing self-placement, find themselves exacerbated[24]. This has had the result of incentivizing management towards the exploitation of the fiduciary relationship between the bank and its clientele[25] to a much greater extent.

After all, it is not by chance that the exercise of resolution or liquidation powers by competent Authorities, in countries where bank crises occurred in

23 Moreover, even if losses were imposed on shareholders, they would in any case maintain the right of being compensated by the «rescuing» bank alleging and proving misselling; whereas, under the current resolution framework, the existence of this chance appears to be strongly controversial. The problem arises with reference to the sale of assets and/or the setting up of a bridge bank within the performance of a resolution action, as German and Italian case law seems to deny that disputed claims would pass on through the purchaser of assets and/or the bridge bank. With reference to Germany, see Landgericht of Munich I, decision of 8 May 2015 – case 32 O 26502/12, reported in BeckOnline Database (file BeckRS 2015, 16096), referred by *Binder,* (fn. 10), p. 9; with reference to Italy, see Court of Appeal of Milan, February 28th 2019, no. 917, available on *Dirittobancario.it*, that overruled Court of Milan, November 8th 2017, no. 11173, *Responsabilità civile e previdenza*, 2018, p. 993, commented by *Vincenzo De Caroli*, "La legittimazione passive degli enti-ponte in relazione a crediti risarcitori per inadempimenti contrattuali, tra problemi di diritto processuale e diritto sostanziale".

24 On this topic, see *Antonella Sciarrone Alibrandi/Ugo Malvagna,* "Self-placement di titoli bancari tra vincoli patrimoniali e tutela dell'investitore", *Banca, borsa, titoli di credito*, 2019, I, 153.

25 It is worth noting that all six bank crises that have occurred in Italy since 2015 concerned cooperative or former cooperative banks, in which the fiduciary relationship between depositors/shareholders (and perhaps borrowers as well) and the bank management is the strongest, giving great latitude for management to leverage on that trust.

the burden-sharing era, has prompted a diversified series of institutional responses aimed at limiting or restoring losses borne by retail investors[26], all of these initiatives being carried out with the approval of DG Comp's Commission. Such a reaction seems to witness to the awareness – at the political level – of the existence of a «gap» in the resolution framework[27].

3. The (Loose) Interplay between Investor Protection and Bank Resolution in the Current Regulatory Environment

3.1. Indeed, it appears that this gap in the current resolution framework consists primarily of a lack of coordination between it and the investor protection framework: more specifically, *on the one hand*, regulations on self-placement just focus on the rule-setting level, without paying proper attention on the issue of how to enforce conduct rules when it comes to a bank's resolution (see *infra*, no. 3.2 and 3.3); *on the other*, the resolution framework does not adequately deal – even after the amendments introduced by BRRD2 (see *infra*, par. no. 5) – with the spillover of serial or massive misselling on the feasibility of resolution (as described above, no. 1 and 2; see also *infra*, no. 4).

3.2. With reference to the former aspect, it should first be pointed out that self-placement had not been addressed at the legislative level until the adoption of the MiFID 2 package. Besides being clarified by the first-level directive that the investor protection framework fully applies to self-placement[28], Delegated Regula-

26 For the first bits of information on these responses, *Guillaume Prache*, "Bail-in: How far does it have to go? The case of the expropriation of share-and bondholders", Better Finance Report, available at http://www.vzmd.si/images/documents/Bailin_-_How_far_does_it_ have_to_ go_-_Better_Finance_-_VZMD_161208.pdf; *Stefano Micossi,* "Testing the EU Framework for the Recovery and Resolution of Banks. The Italian Experience", LUISS Policy Brief – February 15, 2019.

27 From another (but related) angle, a further proof of the current unease with respect to how retail clients are treated in the context of liquidation is highlighted by the huge number of suits that have been brought both in the ECJ (especially with reference to Banco Popular's resolution: see the Report on SRB's, Commission's and Council's contingent liabilities of the European Court of Auditors, published on 21st December 2018) and in national courts. In this respect, some concerns and recommendations have been expressed by the ECA to the effect that the number of court cases is increasing and, because of the complex, specific and completely unprecedented legal system created by the new resolution legal framework, it is difficult to predict the outcome of these many cases at this stage. ECA also warns that more litigation may arise over the next few years.

28 Namely, Article 4(1) no. 5 MiFID II states that «'execution of orders on behalf of clients' means acting to conclude agreements to buy or sell one or more financial instruments on behalf of clients *and includes the conclusion of agreements to sell financial instruments issued by an investment firm or a credit institution at the moment of their*

tion (2017/565) requires, at Article 41, both specific organisational arrangements and additional information requirements in order to address self-placement.

More specifically, according to par. 2 «*Investment firms engaging in the placement of financial instruments issued by themselves or by entities within the same group, to their own clients, including their existing depositor clients in the case of credit institutions, or investment funds managed by entities of their group, shall establish, implement and maintain clear and effective arrangements for the identification, prevention or management of the potential conflicts of interest that arise in relation to this type of activity. Such arrangements shall include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients*»; whereas, according to par. 4, «*investment firms which offer financial instruments that are issued by themselves or other group entities to their clients and that are included in the calculation of prudential requirements specified in [CRR, CRD IV and BRRD], shall provide those clients with additional information explaining the differences between the financial instrument and bank deposits in terms of yield, risk, liquidity and any protection provided in accordance with [the Directive on Deposit Guarantee Scheme]*».

Actually, before the adoption of MiFID2, Supervisory Authorities had already resorted to Level-3 regulation (which can still be considered valid in most respects) specifically dealing with the issue of self-placement carried out by banks, by adopting a Joint Statement (by ESMA, EBA and EIOPA, together the European Supervisory Authorities, or ESAs) on « *Placement of financial instruments with depositors, retail investors and policy holders*» (Self placement)» of May 31st, 2014.

Proceeding from the assumption that «*prudential pressures cannot be allowed to override the obligations on firms to act honestly, fairly and professionally in accordance with the best interests of clients when placing existing or new financial instruments, either on an advised or non-advised basis, and to organise the*

issuance» (emphasis added); whereas under MiFID the absence of such clarification had raised doubts about the fact that self-placement of debt securities issued by banks would fall into the scope of investment services regulations.
A further expansion of the investor protection framework in the field of the banking activity is the application of some MiFID II provisions to structured deposits: in fact, «as they imply the need for additional protection of the customer, their distribution is subject to MiFID standards. The MiFID II package thus attracts, and brings within its scope – and, in particular, in the scope of conduct of business rules – items pertaining to other silos of EU financial legislations: in this case, naturally, banking» (*Filippo Annunziata*, "MiFID as a template. Towards a General Charter for the Protection of Investors and Consumers of Financial Products and Services in EU Financial Law", forthcoming on Quaderni di Ricerca della Banca d'Italia – Bank of Italy Legal research publications).

provision of their services in compliance with these overarching obligations» (p. 5), the Joint Statement provides for some recommendations relating to (i) the management of conflicts of interest, (ii) staff remuneration, (iii) duties to provide information, (iv) the provision of investment advice (as a trigger of the suitability test[29]) and (v) product governance.

The content of the Statement can be summarised by observing that the ESAs' way of addressing investor protection in the field of bank-issued securities basically consists of specifying how general rules of conduct should be applied to the context of self-placement. From the operational standpoint, the salient points of this approach are to be identified in the broadening of the notion of investment advice[30] and the demand for a more detailed and analytic assessment of suitability[31], as well as in stricter control on the manufacturing and

29 Article 25(2) of MiFID II, according to which «*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, that person's financial situation including his ability to bear losses, and his investment objectives including his risk tolerance so as to enable the investment firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him and, in particular, are in accordance with his risk tolerance and ability to bear losses*».

30 See for example the statement of the ESAs' Joint Committee on «*Placement of financial instruments with depositors, retail investors and policy holders*», (Self placement) May 31st, 2014, where it was pointed out that «*As already reminded by ESMA, the presentation of a financial instrument as suitable for the investor, either in an explicit or in an implicit form, constitutes investment advice in accordance with MiFID. In this respect, even in situations in which a firm provides a disclaimer to the client that no recommendation is being given, that firm could still be viewed as providing investment advice*».

31 See ESMA *Guidelines on certain aspects of the MiFID II suitability requirements*, May 28th 2018 (ESMA35-43-748): «*Firms should be especially prudent regarding credit risk: exposure of the client's portfolio to one single issuer or to issuers part of the same group should be particularly considered. This is because, if a client's portfolio is concentrated in products issued by one single entity (or entities of the same group), in case of default of that entity, the client may lose up to his entire investment. When operating through so called self-placement models, firms are reminded of ESMA's 2016 Statement on BRR according to which "they should avoid an excessive concentration of investments in financial instruments subject to the resolution regime issued by the firm itself or by entities of the same group". Therefore, in addition to the methodologies to be implemented for the assessment of products credit risk (see guideline 7), firms should also adopt ad hoc measures and procedures to ensure that concentration with regard to credit risk is effectively identified, controlled and mitigated (for example, the identification of ex ante thresholds could be encompassed)*» (with reference to the MiFID I regime, see Guidelines on certain aspects of the MiFID suitability requirements [ESMA/2012/387]).
See also ESMA *MiFID practices for firms selling financial instruments subject to the BRRD resolution regime*, June 2nd 2016, especially point 27, and ESMA *MiFID II Supervisory briefing on Suitability*, Nov 13th 2018, especially at p. 13, where is stated that when it comes to assessing the suitability of a MREL-eligible security, how the

distribution process through product governance[32] and the imposition of strengthened information requirements caused by the assimilation of all bailinable instruments into complex products[33].

3.3. All of the above is uncontroversial. Indeed, the dynamics underlying self-placement are not inherently different from those that would apply in the general context of the provision of investment services. Rather, the difference pertains to the intensity of those dynamics: conflicts of interest are strongly amplified; «informal» advice is more likely to occur; credit and concentration risks are more insidious; and the complexity of instruments is (after BRRD) higher than for non-bank issued stocks and bonds.

Yet, it is submitted that the main issue, that the current regulatory framework faces with respect to misselling in self-placement of bank-issued securities, concerns enforcement, rather than rule-setting.

In order to illustrate this point, it must be pointed out that, in the context of the regulation of investment services, enforcement of conduct rules is basically grounded – except the recent regulation concerning product intervention of Article 69 of MiFID II – in *ex-post* measures, both public (administrative sanctions) and private (restitution and compensation claims).

The effectiveness of *ex-post* measures, which is traditionally justified by the assumption of its higher efficiency in terms of minimizing transaction costs, is challenged by the coincidence, that characterizes self-placement, between the issuer and the investment service provider (or even, in the case of a public offering of securities, the intermediary in charge of the offering). This is because when

product would behave in the circumstance of the exercise of write-down or conversion powers should be taken into account.

32 «*Investors may find it difficult to understand the drivers of risks and returns of structured retail products (SRPs) and specifies a non-exhaustive list of examples of good practice illustrating arrangements that firms could put in place to improve their ability to deliver on investor protection*».

33 See ESMA Final Report on guidelines on complex debt instruments and structured deposits (ESMA/2015/1783), according to which «*it is the view of ESMA that where a degree of 'uncertainty' exists which prevents retail investors from properly gauging whether their investments in certain debt instruments are at risk either because the firm or a prudential authority exercises discretion to partially or fully writedown (or convert into equity) the bond-holders investments, then these instruments would incorporate a structure which should appropriately be deemed as 'complex'. Therefore, ESMA would like to clarify that, for the purpose of these Guidelines, all bailinable debt instruments are to be deemed complex. This includes all debt instruments which are part of the eligible liabilities under the BRRD with the exclusion of those mentioned under Article 44(2) of the BRRD. ESMA notes that the mentioned criterion should also apply to debt instruments issued by third country entities*».

the issuer has defaulted, or is on the verge of defaulting, *ex-post* means of enforcement are either ineffective or harmful. They are *ineffective*, because actual recovery of compensation or restitution[34] from an insolvent debtor is virtually impossible, unless the purchaser of the failed bank's assets takes on all those contingent liabilities even if not fully quantifiable at the moment of the sale of assets[35]. They can be harmful, because if the existence of a serial or massive misselling is discovered when the bank is still viable, the burden of compensation or restitution claims and administrative sanctions might itself trigger insolvency.

Therefore, the short circuit is easily seen: the paradox of such a situation is that, when the credit institution's capital base is insufficient and, consequently, the risk of a massive breach of conduct rules is higher (since it is more likely that the bank management would engage in serial or massive misselling), *ex-post* measures of enforcement – those on which the current investor protection framework mostly relies upon – simply fail in deterring misselling.

4. The Single Resolution Board's Policy on the Treatment of Retail Clients' Holdings for the Purpose of MREL Eligibility

4.1. The insufficiency of the current approach towards misselling also emerges from a brief analysis of the resolution framework, both at its statutory level and in its implementation by the Single Resolution Board.

In this respect, it is first important to recall that neither BRRD nor the other pieces of the resolution framework deal *specifically* with the issue of how to treat retail clients who are owners of securities subject to loss contribution or bail-in (see *supra*, par. no. 1). Because the requirements of the framework are «objective» (that is, exclusively focused on the inherent features of the securities and not on the characteristics of their owners), the nature of the holder is *prima facie* irrelevant.

Of course, the inclusion of retail clients in burden-sharing and in bail-in, as a general rule of resolution, does not mean that the existence of extensive misselling should not and cannot find any room in the resolution framework. As set out in the introduction to this paper (*supra*, no. 1), the difficulties that misselling poses are all related to the issue of resolvability; that is, the feasibility and credibility of a resolution action which «*avoid[s] to the maximum extent possible any significant adverse effect on the financial system, including in circumstances of broader financial instability or system-wide events, of the Member*

34 It is importantly noted that those claims rank *pari passu* with all the senior debt.

35 On its turn, this would raise further issues that would impact on the resolution feasibility: see infra, no. 4.3 and 6.1, esp. fn. 52.

State in which the institution is established, or other Member States or the Union and with a view to ensuring the continuity of critical functions carried out by the institution» (Art. 15(2) BBRD).

This is, indeed, the Single Resolution Board's approach. Considering the problem from the standpoint of ensuring the credit institution's loss-absorption capacity, the European resolution authority has in fact made the position of retail clients relevant through Article 44(3) BRRD2 with respect to the discretionary exclusion of liabilities according to MREL.

According to this provision, «*in exceptional circumstances, where the bail-in tool is applied, the resolution authority may exclude or partially exclude certain liabilities from the application of the write-down or conversion powers*». The Resolution Authority can exclude some liabilities from MREL[36] when, first, «*it is not possible to bail-in that liability within a reasonable time notwithstanding the good faith efforts of the resolution authority*»; second, «*the exclusion is*

36 The resolution authority is entrusted with a significant degree of discretion as regards excluding eligible liabilities from bail-in. According to Article 44(9) BRRD, «*When exercising the discretions under paragraph 3, resolution authorities shall give due consideration to: (a) the principle that losses should be borne first by shareholders and next, in general, by creditors of the institution under resolution in order of preference; (b) the level of loss absorbing capacity that would remain in the institution under resolution if the liability or class of liabilities were excluded; and (c) the need to maintain adequate resources for resolution financing*».
The exercise of this broad discretion is informed by the criteria laid down in the Delegated Regulation (EU) 2016/860, and especially by Article 8, according to which the Resolution Authority, in deciding whether to exclude some liabilities from bail-in under Article 44(3)(iii) BRRD, must take into account, inter alia, the «*number, size and interconnectedness of institutions with similar characteristics as the institution under resolution, insofar as that could give rise to widespread lack of confidence in the banking sector or the broader financial system*; *...the number of natural persons directly and indirectly affected by the bail-in, visibility and press coverage of the resolution action, insofar as that has a significant risk of undermining overall confidence in the banking or broader financial system*», and «*whether a significant number of counterparties would withdraw funding or cease making transactions with other institutions following the bail-in, or whether markets would cease functioning properly as a consequence of the bail-in of such market participants, in particular in the event of generalised loss of market confidence or panic*». This provision falls under the broader rule of Article 31 BRRD.
It is however submitted that the discretionary exclusion of retail clients-held liabilities would not per se solve the problem, since it would become necessary to find alternative sources of internal financing of the resolution action, otherwise it would just become impossible to carry out the resolution: see *Raffaele Lener/Edoardo Rulli,* "Liabilities excluded from Bail-in: Implications under Italian and EU Law", in Journal of International Banking Law and Regulation, 2017, p. 427 et seq.

strictly necessary and is proportionate to achieve the continuity of critical functions and core business lines in a manner that maintains the ability of the institution under resolution to continue key operations, services and transactions»; third, «*the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium sized enterprises, which would severely disrupt the functioning of financial markets, including of financial market infrastructures, in a manner that could cause a serious disturbance to the economy of a Member State or of the Union*»; and finally, «*the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in*».

Since its 2016 policy on MREL the Single Resolution Board has shown that, in approaching the problem of retail investor protection, it will give relevance to the impediment set out in point (c) of the above-mentioned provision.

Having stressed that there is no «*legal basis for resolution authorities to exclude ex ante and uniformly eligible liabilities held by natural persons or small and medium-sized enterprises from MREL or from bail-in*», the SRB states that the issue of retail investor protection primarily pertains to capital markets law and Authorities: «*the European Union (EU) legislation includes many safeguards to ensure financial products are sold to suitable investors only. The implementation and supervision of such rules is the responsibility of Member States' market authorities*». In light of this, «*any possible failure to comply with investor protection rules is not an argument to exclude these liabilities from the computation of MREL targets or, finally, bail-in*».

However, also the Resolution Authority recognizes that «*holdings of subordinated or senior instruments by retail customers could prove to be an impediment to resolution. As part of the resolvability assessment, the SRB will analyse the bank's exposure to retail bondholders to assess whether the bail-in of these counterparties might be an impediment to resolvability. Acknowledging the benefits of diversification for funding purposes, large holdings of liabilities sold to retail investors could make banks difficult to resolve for various reasons, including (i) the potential loss of a bank's customer base and the risk of withdrawals and (ii) potential litigation brought by retail investors upon or after resolution, which might endanger the bank's future viability*»[37].

37 Minimum Requirement for Own Funds and Eligible Liabilities (MREL) 2018 SRB Policy for the second wave of resolution plans, Parr. 39 and 40, p. 15 et seq.

4.2. The position that EBA and ESMA have expressed on the issue in the recent «Statement on the treatment of retail holdings of debt financial instruments subject to the Bank Recovery and Resolution Directive» of May 30th 2018 is in the same line of the SRB's one.

The content of the Statement is in part identical to the above-mentioned third-level regulation of ESMA on misselling, in particular as it demands for a rigorous application of conduct rules. More importantly, the Statement also suggests that «*when there is a material presence of retail investors, resolution and market authorities could find it beneficial to open a cooperative dialogue and share relevant information, considering the importance of the consumer protection aspect to this topic*».

Finally, the Statement focuses on the relationship between large holdings by retail clients and systemic risk, which is directly connected – in the ESAs view – to the mere fact of bailing-in securities held by retail investors, regardless of the existence of an actual misselling: «*even in the absence of mis-selling cases, the consequences of the application of bail-in to retail debt liabilities, in cases of significant exposures, could also present specific challenges from the perspective of contagion effects and financial instability*». In particular, the bail-in of retail clients-held securities is deemed by the ESAs to be per se (i.e. regardless of misselling) able to prompt an idiosyncratic reaction among savers and investors: «*in certain cases, the loss of a certain financial investment may have a substantial impact on the economic situation of a retail client and his or her household. These elements, when occurring on a sufficiently large scale, may trigger severe reactions in retail customers, which could in turn possibly lead to bank runs*».

The risk of an idiosyncratic crisis triggered by the bail-in of securities held by retail clients would be higher «*in cases where the institutions place their debt securities directly with their own retail clients (self-placement)*». In fact, the circumstance according to which «*retail bondholders are also clients of the institution*» might mean that «*their bail-in would damage the customer base and reputation of the institution, which could in turn make it more challenging for resolution authorities to restore the franchise value and business viability of the institution after resolution*».

4.3. The above clearly shows that the Single Resolution Board and the ESAs focus exclusively on quantity: that is, on the overall exposure of banks to retail clients. More specifically, large holdings of bail-inable securities among retail clients are seen as a potential impediment to resolution for three main reasons: a) the reduction of the bank's customer base, b) litigation brought by retail investors, and c) the investors' inability to bear losses.

All of these elements are analysed by the SRB and ESAs both from the point of view of the risk of contagion [*sub specie* of «direct» contagion[38] (issue *sub* c) as well as of a loss of confidence in the financial system (issue *sub* a)], and from the point of view of the practical impossibility of performing the resolution (issue *sub* b).

The end result of this approach points to discouraging excessive *aggregate* holdings by retail clients, both through MREL calibration and (consequently) through providing limits to self-placement as a financing channel. Actually, the SRB's willingness to pursue these goals is much clearer in the 2016 report than in the subsequent ones: the 2016 report states that «*the SRB will further assess significance of retail investors in different Member States and develop potential measures to address the issue, for instance, by means of higher MREL, subordination requirements*», or even «*requesting adjustments to banks' funding strategies, should the situation be considered an impediment to a bank's resolution*». Due to the confidentiality of resolution planning, it is unknown to us how this aspect has been concretely addressed.

It is submitted, however, that all of the three potential impediments to resolution set forth above, as well as others that may arise as a consequence of involving households in the cost of a bank's resolution (a couple of further examples are provided at the end of this par. 4.3), are much more the result of large-scale misselling of MREL-securities than of the mere existence – at the moment of resolution – of large holdings of own funds and eligible liabilities by retail clients.

With reference to the issue *sub* a) (the loss of the bank's customer base), the risk of a post-resolution idiosyncratic crisis is higher in the case of an open-bank bail-in. On the contrary, when the resolution is carried out through more standard tools (at least for non-systemic banks), namely the sale of assets to another credit institution, this risk should be lower: the ability of the purchasing

38 See EBA's *Technical advice on the delegated acts on the circumstances when exclusions from the bail-in tool are necessary*, March 6th 2015 (EBA/Op/2015/07), p. 13 «Types of contagion *45. In principle, two types of contagion potentially resulting from bail-in can be distinguished: (a) Direct contagion means that direct losses of counterparties of the institution under resolution, resulting from the write-down of the institution's liabilities, lead to default or solvency issues for those counterparties, and in turn in losses for their counterparties, and for counterparties of these counterparties and so on. The same applies to issuers of credit default swaps (CDSs) relating to these liabilities where they are triggered. (b) Indirect contagion is caused by the reactions of market participants to the failure of the resolution action. An important channel of indirect contagion may be the loss of confidence in funding markets (retail and wholesale) – drying up of supply, higher margin requirements in general or for institutions with similar characteristics as the failing institution, fire sales of assets by institutions with liquidity shortfalls*».

bank would in fact be sufficient to restore the confidence of depositors and other clients.

As far as issue *sub* b) (litigation brought by retail clients) is concerned, it can be readily noted that the risk of *relevant* litigation (i.e., litigation whose size could affect the resolution's feasibility) brought by shareholders involved in the burden-sharing or bail-in arises only when it is likely, or at least not improbable, that a large-scale misselling occurred.

Finally, with regards to issue *sub* c) (retail investors' lack of ability to bear losses), it is argued that the inability of households to bear the losses entailed by bail-in or write-down of securities does not automatically depend on their nature as retail clients, but instead (as was said above, no. 1) on the impact that losing their investment would concretely have on each individual investor, taking into account its assets, income, risk-tolerance and portfolio concentration.

As seen *supra* (no. 3), in the operational context of misselling, this issue is dealt with – even if only in the perspective of rule-setting – in level-3 regulation, by expanding the notion of investment advice[39], and, consequently, imposing the carrying out of a suitability test, which in fact requires the investment service provider 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 so as to enable the investment firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him and, in particular, are in accordance with his risk tolerance and ability to bear losses*» [Article 25(2) MiFID 2].

There are also potential impediments, additional to the ones highlighted by the Single Resolution Board. For instance, it has been correctly observed[40] that the occurrence of relevant litigation could trigger a practical impossibility of carrying out the resolution in a reasonable time under Article 44(3)(a) BRRD. In addition, also the difficulty in assessing the overall liabilities of the bank as a consequence of significant misselling can constitute a cause of destruction in value under Article 44(3)(d) BRRD. This issue is related to the uncertainty of

39 This expansion is even broader than that affecting investment services in general: on this topic, see *Olha O. Cherednychenko*, "Contract Governance in the EU: Conceptualising the Relationship between Investor Protection Regulation and Private Law", in European Law Journal 21 (2015), 503. Anyhow, it is a well settled principle that «*the fact that a recommendation is made to multiple clients would not automatically mean that it could not be a personal recommendation*» (CESR/10-293, Q&A Understanding the definition of advice under MiFID, par. 68).

40 By *Binder*, (fn. 10) p. 13.

the amount of the liabilities that would pass on to the purchaser of the bank's assets. Such a situation is likely to cause an «overdiscount» of the assets purchase price, unless liabilities related to restitution/compensation claims are bailed-in or excluded from passing onto the purchaser (which, on its turn, would require their prior assessment, and would anyway raise a problem of compliance with the no-creditor-worse-off principle). This problem is in addition to the general issue of «fire sales» by the purchaser of the assets of a resolution entity[41].

Nevertheless, also these further issues arise only when there is at least the risk of relevant (but still unknown in their actual dimension) liabilities due to misselling in self-placement.

4.4. In light of the above, we conclude that, when considering the position of retail holders of bail-inable securities, one shouldn't focus simply on the aggregate size of the holding in respect of the total bank liabilities. As a matter of fact, this aspect alone does not raise the concerns set out above (as well as the others referred to *supra*, no. 1). Rather, attention should be paid to quality as well as it already is to quantity.

5. Art. 44 a BRRD 2 on the «Selling of Subordinated Eligible Liabilities to Retail Clients»

5.1. The BRRD 2 amendments are to some extent in line with the idea that the core problem to address in the context of self-placement of MREL-eligible instruments is to enhance the quality of its distribution process (instead of

41 One way to avoid impediments under Article 44(3)(a) and (d) could be to completely prevent liabilities arising from misselling to pass on through the acquiring bank, as happened in the case of the Venetian Banks' liquidation, whose Decree Law [no. 99/2017] provides, at Article 3, that it excludes from liabilities transferred to the purchaser «*i debiti delle Banche nei confronti dei propri azionisti e obbligazionisti subordinati derivanti dalle operazioni di commercializzazione di azioni o obbligazioni subordinate delle Banche o dalle violazioni della normative sulla prestazione dei servizi di investimento riferite alle medesime azioni o obbligazioni subordinate, ivi compresi i debiti in detti ambiti verso i soggetti destinatari di offerte di transazione presentate dalle banche stesse*». It is submitted, however, that such a choice – if made in the context of a resolution action – would very probably result in a breach of the no-creditor-worse-off principle. At the same time, it wouldn't be able to overcome the three issues set out by the SRB, mentioned *supra*, which mainly points to Article 44(3)(c). As a matter of fact, this option would run counter to the idea that compensation claims are (perhaps the most important) component of MiFID II enforcement of conduct rules, so much so that it is correctly argued that it is EU law itself that mandates private enforcement of these rules (see *supra*, fn. 8).

merely setting out an aggregate threshold of securities held by retail investors in respect of the overall own funds and eligible liabilities).

Indeed, it is submitted that this approach appears to be the most efficient one, as far as it achieves the aim of ensuring that the credit institution maintains actual loss-absorption capacity, and does not prevent or limit self-placement as a channel of financing. Such a rule would in fact be overinclusive, *i.e.* too broad for its protective purpose (in all cases that the investment would be suitable for a retail client), and would also prejudice banks that rely on retail investors as a channel for financing, thus breaching the level playing field paradigm.

Conceptually, the new provisions set by BRRD2 are more focused on investor protection rather than on typical resolution issues. As recital 16 of BRRD2 states, the focus is «*to ensure that retail investors do not invest excessively in certain debt instruments that are eligible for the MREL*», provided that the current MiFID 2 framework is deemed to be incomplete in this respect: «*this requirement is not sufficiently covered in Directive 2014/65/EU*» and «*should therefore be enforceable under Directive 2014/59/EU and should be without prejudice to investor protection rules provided for in Directive 2014/65/EU*».

In order to reach the objective of a non-disproportionate investment by retail clients in MREL instruments, Member States are thus required to «*ensure that the minimum denomination amount of such instruments is relatively high or that the investment in such instruments does not represent an excessive share of the investor's portfolio*».

An enhancement of the quality of self-placement is also (tried to be) achieved in the BRRD 2[42] through a provision regarding information exchange between market and resolution authorities: «*where, in the course of performing their duties, resolution authorities find evidence regarding potential infringements of Directive 2014/65/EU, they should be able to exchange confidential information with market conduct authorities for the purpose of enforcing that Directive. In addition, it should also be possible for Member States to further restrict the marketing and sale of certain other instruments to certain investors*».

5.2. The principles set out in the above recital are spelt out in Article 44a (*Selling of subordinated eligible liabilities to retail clients*)[43].

At the outset, it is important to consider the objective scope of the rule, which includes eligible liabilities[44] that do not qualify as CET1, AT1 or T2 items. The

42 Applicable to liabilities issued after 28 December 2020 [Article 44a(7)].

43 The origin of this provision can be traced back to *Conac*, Mis-selling of Financial Products (fn. 22), p. 45.

44 See Articles 72a and 72b of CRR2.

extension of the rule to own funds can be opted-in by Member States: «*notwithstanding the first subparagraph, Member States may provide that the conditions laid down in points (a) to (c) of that subparagraph shall apply to sellers of other instruments qualifying as own funds or bail-inable liabilities*».

The substantive content of the rule is composed of two concurrent layers. First, Article 44a(1) requires a suitability test to be carried out in every case of selling MREL-eligible subordinated debt to retail investors, regardless of the investment service under which the security is negotiated or the identity of the seller of the instrument: «*Member States shall ensure that a seller of eligible liabilities [that are within the scope of application described above] sells such liabilities to a retail client, as defined in point 11 of Article 4(1) of Directive 2014/65/EU, only where all of the following conditions are fulfilled: (a) the seller has performed a suitability test in accordance with Article 25(2) of Directive 2014/65/EU; (b) the seller is satisfied, on the basis of the test referred to in point (a), that such eligible liabilities are suitable for that retail client; (c) the seller documents the suitability in accordance with Article 25(6) of Directive 2014/65/EU*». The effect of such provision is to subject those transactions to the suitability regime instead of the appropriateness one, that would otherwise be applicable.

In addition to the mandatory suitability test under Article 25(2) (see supra, no. 4.3), a further layer of protection is provided by par. 2. This additional protection, which applies only to investors whose financial instrument portfolio[45] is less than EUR 500 000[46], demands that two conditions are simultaneously met: «*(a) the retail client does not invest an aggregate amount exceeding 10% of that client's financial instrument portfolio in liabilities referred to in paragraph 1*» and «*(b) that initial investment amount invested in one or more liabilities instruments referred to in paragraph 1 is at least EUR 10 000*»[47].

It is, however, possible for Member States to opt-out of the protection provided in parr. 1 to 4 provided that «*Member States may set a minimum denomination amount of at least EUR 50 000 for liabilities referred to in paragraph 1, taking into account the market conditions and practices of that Member State as*

45 Par. 4 clarifies that «*the retail client's financial instrument portfolio shall include cash deposits and financial instruments, but shall exclude any financial instruments that have been given as collateral*».

46 «*On the basis of the information provided by the retail client in accordance with paragraph 3*», according to which «*The retail client shall provide the seller with accurate information on the retail client's financial instrument portfolio, including any investments in liabilities referred to in paragraph 1*».

47 It is interestingly noted that these two provisions are also provided in other areas of capital markets, namely ELTIFs marketed to retail clients.

well as existing consumer protection measures within the jurisdiction of that Member State».

Additionally, par. 6 provides that «*Where the value of total assets of entities referred to in Article 1(1) that are established in a Member State and are subject to the requirement referred to in Article 45e does not exceed EUR 50 billion, that Member State may, by way of derogation from the requirements set out in paragraphs 1 to 5 of this Article, apply only the requirement set out in paragraph 2(b) of this Article»*.

5.3. The regulation set forth in Article 44a BRRD 2 is of great interest and raises several issues. Indeed, we see both light and shadow in this amendment.

Beginning with the features of the amendment that can be agreed on, it is remarkable that it contains a dedicated provision within resolution legislation dealing with retail investor protection.

Moreover, it is important to appreciate that this issue is approached in a way that attempts to coordinate the area of bank-issued securities with the investor protection framework; that is, it resorts to the same conceptual apparatus and normative toolkit that characterizes investment services regulation in general (the suitability regime, limits on portfolio concentration, and minimum investment thresholds), expanding its scope of application. Anyhow, the idea of making the suitability test the general conduct standard when negotiating bank-issued securities deserves appreciation at least in the case of self-placement, as far as such provision basically relieves the investor of the difficulties of proving that «*the presentation of a financial instrument as suitable for the investor, either in an explicit or in an implicit form*»[48] (thus triggering the suitability regime), which is hard to demonstrate but corresponds to the reality of those transaction in the vast majority of cases. From this standpoint, this less onerous burden of proof appears to be more efficient.

In addition, it has to be stressed out the importance of the urge – in Recital 16, but unfortunately not in a normative provision – for an exchange of confidential information between resolution and market authorities, which is aimed at a timelier exercise of the market authorities' powers (on the importance of this Recital, see infra, no. 6).

5.4. However, we argue that these arrangements are not enough to achieve the goal of an adequate level of protection of retail investors in bank-issued securities. Two main critical remarks can, in our opinion, be offered with respect to Article 44a. The first one and involves the consistency of its substantive provi-

48 ESAs' Joint Committee on «Placement of financial instruments with depositors, retail investors and policy holders» (Self placement), May 31st, 2014.

sions with the analytical premises behind the introduction of the rule (in this par.). The second and most important pertains to the means of its enforcement (see par. no. 6).

As far as the consistency of its substantive provision is concerned, we argue that the limitation of the rule's objective scope (excepting the opt-in rule set out in par. 1) to MREL-eligible liabilities that are not composing own funds (that is, not qualifying as tier-1 or tier-2 items under CRR) is not fully intelligible.

If Article 44a's underlying logic is to avoid the risk that the need for banks to comply with CRR and BRRD capital ratios will result in systematic pressure on their retail clientele to buy bank-issued securities in disregard of their best interest, then it is apparent that such a risk arises from all kinds of securities, regardless of their nature of equity, hybrid or debt (more broadly, their place in the hierarchy of the bank's insolvency or in the going-concern loss absorption capacity).

From the same perspective, a problem of internal consistency is also posed by the fact that Article 44a's scope of application is not limited to self-placement (i.e. to the selling of instruments by the issuing bank or by an entity belonging to the issuer's banking group), but is instead *de plano* applicable to any «seller» of eligible liabilities.

It can be readily seen, in this respect, that when the investment service provider selling a bank-issued instrument is not linked or related to the issuing bank or its group, no significant conflicts of interest should be entailed *by the mere fact*[49] that the object of the investment is a bank-issued security: *on the one hand*, an intermediary with no structural links with the issuing bank is by definition not involved in the latter's prudential concerns; *on the other hand*, MiFID 2 strongly narrows the room for legitimate provision of inducements to distributors, which are now allowed only in specific situations where the intermediary *already has to apply the suitability regime*[50].

49 With reference to the hypothesis of intermediaries (unrelated to the issuer) «dumping» their or their clients' subordinated debt instruments in the proximity of the issuer's insolvency (expected by the intermediary and unknown to the purchasing retail investor), the application of the suitability regime on top of rules on appropriateness and conflict of interests seems of little help, since those transactions are flawed not by direct reason of their inconsistency with the retail client's investment objectives and risk tolerance, but because of the omission of relevant information by the intermediary due to a conflict of interests.

50 See Article 24(9) MiFID 2 and Article 11 of the Delegated Regulation 2017/593.

One could then argue that the introduction of Article 44a is the consequence of the inherent complexity of bail-inable instruments, rather than of the existence of a peculiarly high risk of conflicts of interest in the issuing bank (for reasons of regulations on capital). However, this objection can be countered by noting that if such a rule exists *exclusively* because of an instrument's complexity, then it would draw an unreasonable discrimination between bank-issued securities and other kinds of complex instruments. Besides, such a justification would not explain why the rule refers to MREL-eligible liabilities not composing own funds. In fact, all these instruments are complex since, given the existence of a vast discretion by the Resolution Authority in performing resolution, it is hardly possible to gauge the risk of an instrument being actually subject to bail-in and to what extent[51].

Ultimately, the decision to compel the application of the suitability rule for the purchase of any bank-issued subordinated debt instruments, regardless of the identity of the seller as well as of the context where the negotiation takes place, seems to blur the two different policy objectives discussed above (no. 4), that is: discouraging on a general basis the *aggregate* amount of holdings by retail investors, by raising the related transaction costs (quantitative approach); and ensuring that retail clients' investment in bank-issued securities are objectively in line with their capacity to absorb losses (qualitative approach).

Summarising, we argue that if an instrument is sold by an investment firm that is not linked to the issuing bank in breach of rules providing retail clients with protection (as enhanced by special regulations on complex instruments), the correct response should be found in the investment services framework, without the need for differentiated (and more burdensome than the ones generally applicabile to investment services) substantive rules. Conversely, when self-placement occurs, the restriction of the scope of Article 44a's applicability to MREL securities other than own funds seems to underestimate that the reasons for a special protection for retail investors are also present in the selling of instruments that qualify themselves as items of Tier 1 and Tier 2 (own funds).

51 On this topic, see *Tobias H. Troeger*, "Why MREL won't help much: minimum requirements for bail-in capital as an insufficient remedy for defunct private sector involvement under the European Bank resolution framework", Journal of Banking Regulation, 2020, 64; *Edoardo Martino*, "*The Bail-in Beyond Unpredictability: Creditors' Incentives and Market Discipline*", European Business Organization Law Review, June 8th 2020, https://doi.org/10.1007/s40804-020-00188-7.

6. The Need for a More Effective Integration between Investor Protection and Bank Resolution: from an Ex-post to an Ex-ante Approach. The Role of Product Governance under MiFID 2

6.1. But the core flaw of Article 44a is that it falls short of clarifying how its substantive provisions should be enforced. Thus, the application of the investor protection is left, also in the context of the application of the resolution framework (resolution planning *and* actual resolution actions), on *ex-post* means.

However, relying on *ex post* means of enforcement in the field of self-placement is not sufficient to prevent serial or massive misselling, insofar – as recent history has proven (see supra, no. 2) – actual award of compensation/restitution by definition occurs way after the infringement: and by that time, the bank could be already gone into bankruptcy or could be in a situation where compensation claims or administrative sanctions would themselves trigger insolvency (thus promoting the management's moral hazard). Eventually, this makes ex post enforcement alone unfit to prevent misselling spillover effects on the resolution's feasibility, either in terms of practical impossibility to carry out the resolution action in a reasonable time, or in the terms of causing a widespread contagion, or even because of the breach of the no-creditor-worse-off principle (see the analysis carried out s*upra*, no. 3.2)[52].

All the above calls for a shift in the chosen approach in enforcing investor protection rules: *namely*, focusing on an ex-ante strategy, rather than an ex-post one.

52 Indeed, when it comes to deciding how to address the resolution of a bank where serial or extensive misselling has taken place, only three basic alternatives are on the table: *either* analytically ascertaining the bank's total exposure to claims arising from misselling and taking it into consideration as forming the liability side before taking any final resolution action; *or* requiring the assets' purchaser to take on all debts including the one arising from misselling, even if not analytically quantified (this is what happened in the Banco Popular's resolution case); *or even* preventing those claims from passing onto the assets' purchaser through the bail-in or the asset separation tool (like in the Venetian Banks' liquidation; see supra, footnote no. 43). In all cases, performance of the resolution action would face outstanding legal risks and operational difficulties: in the first case, a timely performance of the resolution action would be barely impossible; in the second case, the risk of a fire sale would be exacerbated; in the third case, creditor under those claims would almost certainly be prevented from recovering any sum: but this would result in a breach of the no-creditor-worse-off rule, besides the fact that denying actual enforcement would inflict a serious wound to retail investors' trust in the financial system.

This would require structural integration of investor protection issues in the resolution activity, in order to place the Resolution Authority in the position of being able to fully understand – since the stage of resolution planning and MREL-setting – the impact that misselling could have on the resolution's feasibility, and act accordingly.

In the absence of a clear-cut regulation of this aspect, the embedding of investor protection in the resolution activity (even if limited as what concerns the resolution viability) requires to face some doubts shed by Article 44a. As a matter of fact, it is far from clear *(a)* which Authority, if any, is in charge of supervising compliance with Article 44a, *(b)* what the actual terms of such supervision needs to be, and *(c)* what the consequences of breaching Article 44a are.

6.1.1. With reference to the first issue, it is uncertain whether supervision of compliance with Article 44a should rest within the SRB or the Market Authorities. Indeed, the assumption that verifying the issuer-seller's compliance with Article 44a is the duty of the SRB is far from self-evident. From a certain point of view, it can be argued that this provision belongs to the resolution framework (as it is embedded in BRRD and specifically, in the section dedicated to the bail-in tool); from another, it is still true that its substantive provisions pertain to investor protection, referring to rules set out in MiFID 2.

Nevertheless, it is submitted that the *sedes materiae* is meaningful in indicating that the purpose of these rules is to strengthen the loss-absorption capacity of the credit institution, in the perspective of both the resolution planning and the actual exercise of resolution powers. Arguably, this entails that the review and assessment of the sellers' compliance with Article 44a ultimately[53] falls into the responsibility of the Single Resolution Board, which should then receive and have access to information which is relevant for this purpose. Besides, it should be noted that recital 16 of BRRD2 states that – since MiFID is not addressing sufficiently the risk of avoiding that «the investment in such instruments does not represent an excessive share of the investor's portfolio – this requirement «should therefore *be enforceable under* [BRRD] and should be without prejudice to investor protection rules provided for in [MiFID]».

6.1.2. As far as the content of this review is concerned, the question is whether it is the competent authority's duty just to verify that Article 44a has been *formally* complied with (*i.e.*, the mere fact that the bank has documented the suit-

53 Whereas the adoption of administrative sanctions or supervisory measures under MiFID 2 is the Market Authorities' responsibility, as it is clearly stated by Recital 16 BRRD2.

ability), or whether it must conduct a more thorough review of the merits of the suitability assessment performed by the seller.

Given the above, it is argued that the assessment of the suitability test's performance should work as the information basis on which the Resolution Authority evaluates the actual compliance of the credit institutions with the investor protection framework, to the purpose of assessing the effects arising from the writing-down or conversion of the pertinent instruments (that is, of answering the question about whether a serial or massive misselling has taken place). Besides, embracing this line of reasoning seems the only way to give some sense to Recital 16, according to which *«where, in the course of performing their duties, resolution authorities find evidence regarding potential infringements of Directive 2014/65/EU, they should be able to exchange confidential information with market conduct authorities for the purpose of enforcing that Directive»*.

6.1.3. Finally and more importantly, a serious problem faced by Article 44a is the unclear relationship that it draws between its compliance and the loss absorption capacity of the pertinent instruments.

The question is raised by the fact that compliance with Article 44a is not expressly set out as a requirement for including liabilities in the MREL, or to make it contribute to the internal recapitalization in the actual exercise of resolution powers. Nor it is specified which steps should the Resolution Authority take in case it is not satisfied about how the suitability tests are carried out. This central issue remains unresolved by the legislative amendment.

It is therefore argued that, in the absence of an express regulation of those aspects, substantial compliance with Article 44a is a piece of information that should be taken into consideration by the Resolution Authorities when exercising all its discretionary powers.

6.2. Against this backdrop, still it is apparent that charging the Resolution Authority with the task of assessing large-scale compliance of self-placement with the suitability regime under Article 44a is as necessary to a proper resolution planning, as it is extremely complex and burdensome. For sure it would be impossible (and in any case too costly) to carry out this task in every relevant case, as far as the process is thought as an assessment of the breach of conduct rules with reference to *each individual contractual relationship.*

Nevertheless, proceeding from the assumption that misselling would hamper the resolution feasibility only as far as it has a *serial character* thus showing a flaw in how the distribution strategy is conceived and/or implemented at its general level (see above, no. 1), then the Resolution Authority should aim at having a comprehensive understanding of the quality of the self-placement process *from a global perspective*, in terms of the single institution's actual level

of compliance with Article 44a. The assessment should be based on firm-level parameters, indicators and triggers[54].

This approach also suggest how should the Resolution Authority concretely perform such kind of review. In fact, the idea that investor protection rules' enforcement should not be left to ex-post remedies, but should rather be approached at the level of constantly ensuring and monitoring the *quality of intra-firms processes* regarding the phases of product design and setting of the distribution strategy, and that failure to do that would trigger supervisory measures including the ban on selling certain financial instruments, already underpins the new European legislation on investment services and products.

Going far beyond the mere imposition of organizational duties in order to comply with rules of conduct relating to conflict of interests (which was already there in MiFID[55]), MiFID 2 requires investment firms to put in put in place a so called «product governance» process: specifically, Article 16 (3), second sentence, of MiFID 2 provides that «*an investment firm which manufactures financial instruments for sale to clients shall maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients*».

The purpose of the approval process is to make the manufacturer of a financial instrument expressly assume responsibility about the target market the instru-

54 That is, benchmarks apt to highlight anomalies in the placement and/or distribution process of self-issued securities and, accordingly, at assessing whether it can be reasonably ruled out that a significant misselling occurred or, if it did occur, at quantifying its scope.
Examples of relevant benchmarks could be, among others: (*i*) a particularly high rate of self-issued instruments held by retail clients, as compared to the relevant market (i.e. national market) and the nature of the bank, including its size, complexity and client base; (*ii*) unequal treatment between self-issued products and other products, as well as an assessment of the bank instruments' level of risk/complexity; (*iii*) commercial policies geared to systematically preferring self-issued products, including, inter alia, employee remuneration policies and the existence in a significant number of cases of excessive concentration of investment in self-issued securities; (*iv*) modification of the risk profile of a significant number of retail clients just before the start of a self-financing campaign (through the raising of capital or otherwise); (*v*) the absence in a significant number of cases of the written investment contract or the absence in a significant number of cases of the «MiFID profiling» questionnaire; and (*vi*) the absence in a significant number of cases of proper information about conflicts of interest.

55 See now MiFID 2 Article 16(3), first sentence «*An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 23 from adversely affecting the interests of its clients*».

ment is intended for: «*the product approval process shall specify an identified target market of end clients within the relevant category of clients for each financial instrument and shall ensure that all relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market*».

On its turn, the underlying principle driving the identification of the target market is that the instrument meet the actual financial needs of clients falling into the target: according to Article 24 (2) MiFID 2, in fact, «*investment firms which manufacture financial instruments for sale to clients shall ensure that those financial instruments are designed to meet the needs of an identified target market of end clients within the relevant category of clients*»[56].

Not only the Directive requires investment firms to identify the target market, but also demands that intermediaries ensure that «*the strategy for distribution of the financial instruments is compatible with the identified target market*» [Article 24 (2) MiFID 2]. The ultimate purpose of this process is to lead a situation where «*financial instruments are offered or recommended only when this is in the interest of the client*»[57] in terms of investment objectives and risk tolerance[58].

If properly implemented, this regulatory approach – where supervised firms are required to «*engage in self-critical evaluation and learning about their regulatory performance in an uncertain environment*»[59] – should also force supervised entities to develop review processes apt at detecting, through objective

56 It is also interestingly noted that MiFID 2 delegated Directive (EU/2017/593) clarifies the need for a *specific* spelling out of the target market: according to Article 9(1): «*Member States shall require investment firms to identify at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives the financial instrument is compatible. As part of this process, the firm shall identify any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible*». This has been done by the ESMA guidelines on product governance, which defines client's needs in terms of consistency of the instrument with the following aspects: a. «*type of client*», b. «*knowledge and experience*», c. «*financial situation with a focus on the ability to bear losses*», d. «*risk tolerance and compatibility of the risk/reward profile of the product with the target market*», e. «*clients' objectives and needs*». ESMA35-43-620, February 5th 2018, Guidelines on MiFID II product governance requirements, pages 6f.

57 Article 24(2) MiFID 2, last sentence.

58 Besides, Level-3 provisions would still apply: namely, the ESA's Joint Statement on «*Placement of financial instruments with depositors, retail investors and policy holders*» (Self placement)» of May 31st, 2014 (see above, no. 3.2)

59 *Olha O. Cherednychenko*, Public and private financial regulation in the EU: opposites or complements?, in: Nicholas Dorn (ed.), Controlling Capital: Public and Private Regulation of Financial Markets, 2016, 149.

parameters, when there is evidence of failure to correctly implement the investor protection framework[60].

In this context, the Resolution Authority should rely on the outcomes of product governance, and its supervision carried out by Market Authorities through proper form of cooperation[61], as information assets that are fundamental to the purpose of proper exercise of its role and functions[62].

As a matter of fact, this would lead to actually embedding investor protection in the resolution framework, thus developing an enforcement approach which is: (*a*) more clearly oriented towards preventive means, and (*b*) not just focused on the single episodes of misselling, but keener on considering the activity as a whole, *i.e.* on the assessment the overall quality of the distribution process of self-issued instruments.

This is particularly relevant in case of new issuances of MREL-securities that are intended for retail investors. In this case, it is appropriate for the Resolution Authority to carry out – in close cooperation with Market Authorities – a preliminary assessment on the absence of the risk of a serial misselling occurring, to the purpose of deciding about the actual MREL-eligibility of self-placed instruments purchased by retail investors.

60 See above, fn. 54.

61 In this field, a great deal of importance is attached to the growing use of advanced technologies in the performance of supervision activity (so called Sup-Tech): see *Douglas W. Arner/Jànos Barberis/Ross P. Buckley*, "FinTech, RegTech and the Reconceptualization of Financial Regulation", Northwestern Journal of International Law & Business 37 (2017), 371; *Veerle Colaert*, "RegTech as a response to regulatory expansion in the financial sector", available on https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2677116; *Yueh-Ping (Alex) Yang/Cheng-Yun Tsang*, "RegTech and the new era of financial regulators: envisaging more public-private- partnership models of financial regulators", *University of Pennsylvania Journal Of Business Law* 21:2 (2018), 354; Institute of international finance, *RegTech in financial services: technology solutions for compliance and reporting*, March 2016.

62 With reference to MREL-instruments election, it is clear that the Resolution Authority's decision – based on its assessment, performed after proper forms of cooperation with market Authorities – of excluding liabilities whose distribution process is deemed to be «flawed» (in terms of compliance with the investor protection regulations), even if not constituting *in itself* a ban on the marketing of self-issued securities, works on a *de facto* level as a powerful incentive towards a more effective protection of retail investors' interests in self-placement. Conceptually, this action shows an indirect homogeneity with supervisory measures granted to Market Authorities by Article 69 MiFID II, according to which competent Authorities can also «*suspend the marketing or sale of financial instruments or structured deposits where the investment firm has not developed or applied an effective product approval process or otherwise failed to comply with Article 16(3) of this Directive*»: par. 2 (t).

7. Concluding Remarks

This paper has addressed the issue of misselling in self-placement of bank-issued securities in the light of the resolution framework. As explained, the resolution's feasibility could be hindered by the occurrence of serial misselling in self-placement of the failing bank securities, due to the difficulty to ascertain the actual size of liabilities relating to misselling (in the form of compensation and/or restitution claims) in a time that is compatible with the need of a resolution action and, consequently, to treat those creditors in ways that are in line with the no-creditor-worse-off principle.

Article 44a of BRRD2 tries to address such shortcoming by expanding the scope of application of MiFID 2 suitability regime to the selling of all bank-issued subordinated debt instruments (with an opt-in by Member States to extend the rule's scope of application to their instruments qualifying as own funds or bail-inable liabilities). This rule requires approval when it calls for (or allow) the application of the suitability test for all cases of self-placement, given the fact that in most cases the selling of a self-issued instrument is the outcome of an informal investment advice coming from the bank.

It is submitted, however, that, when it comes to self-placement of bank-issued securities, ex post means of enforcement cannot be the only tools the implementation of the resolution framework relies on. This is mainly due to the fact that, when the bank is on the verge of the insolvency, private law remedies cannot work as a deterrence the breach of conduct rules, so that they cannot prevent spillover effects of misselling on the resolution's feasibility.

Against this backdrop, we suggest to construe Article 44a in such a way as to urge for the set-up of an *ex ante* and ongoing control by the Resolution Authority on the actual level of compliance of each single credit institution with the investor protection framework (namely, the suitability rule whose application is demanded by Article 44a). Given the impossibility to carry out this task by assessing each single contractual relationship where self-placement occurs, and provided that misselling can hamper the resolution feasibility only when it is relevant in size (that is, when it has a serial or massive nature), we suggest that the review carried out by the Resolution Authority should be based, in the first place, on the review of the product governance process's outcomes that (also) banks are required to establish under MiFID 2. If properly implemented, product governance would constitute the core informational basis to let the Resolution Authority shift the enforcement approach of Article 44a from an ex post to an ex ante one. In order to reach such goal, we also advocate the development of forms of close cooperation with Market Authorities. This could also be helpful to put the Resolution Authority in the position of being able to assess the existence of further areas of non-compliance

with conduct of business rules, besides the case of misselling in placing self-issued instruments.

Ultimately, it is our take that principles underlying the investor protection framework and the resolution one can effectively work only if mutual cooperation between market and Resolution Authorities aims at their comprehensive implementation.

On the contrary, leaving the problem of the quality of the allocation process (*i. e.* the potential existence of large-scale misselling) to *ex post* remedies risks to put the Resolution Authority in a dead end: either ignoring the fact that misselling occurred (thus breaching, arguably, the no-creditor-worse-off principle), or being too loose in exempting retail investor from burden sharing (thus prompting the need of finding other resources in order to ensure the institution's loss absorbing capacity). Anyhow, both behaviors would end up in neglecting – with respect to retail investors – the principle of market discipline, which the investor protection regulations (by promoting a fair risk-taking by investors) and the resolution framework (by discouraging moral hazard as the consequence of the burden sharing principle) declare to pursue as one of their core goals.