Corporate and Financial Markets Law

The Expanding Boundaries of MiFID's Duty to Act in the Client's Best Interest: The Italian Case

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Abstract

MiFID requires investment firms to act in accordance with the best interests of their clients. This overarching principle shapes firms' professional conduct in at least two ways. First, it sets a general standard firms have to comply with when dealing with their clients, and its breach may lead to civil remedies for clients or administrative sanctions for investment firms. Second, the duty is the backbone of the detailed conduct of business rules within the body of MiFID II and its implementing measures, playing a role in their interpretation. In this paper, we analyse the duty to act in the clients' best interest within the MiFID II framework, and illustrate its practical relevance by looking at its role in Italian financial markets law. More specifically, after recalling how the duty came to be an essential part of the ISD/MiFID framework, we map how the duty is spelt out, at various junctures, in the Directive and highlight its functions. Next, we look into how the duty operates with reference to different investment services and activities covered by MiFID II, claiming that the duty is quite difficult to reconcile with services characterized by at-arms'-length relationships between the investment firm and the client. Then, we focus on the use of the duty in the law in action of one member state, Italy, where retail investors have suffered from egregious cases of mis-selling of bonds issued by the banks acting as their investment services providers. We conclude that the MiFID II regime falls short of clarifying with sufficient precision the implications of the best interest duty and, at least in the civil law jurisdiction we focus on (Italy), significantly expands the scope for judicial review of purely arms-length firms-clients relationships.

I. Introduction

Like its predecessors,[1] Directive 2014/65/EU (hereinafter: MiFID II) requires investment firms to act in accordance with the best interests of their clients (Art 24(1)). This overarching principle shapes firms' professional conduct in at least two ways. First, it sets a general standard firms have to comply with when dealing

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[1] See Art 11(1) Directive 93/22/EEC (hereinafter 'ISD' (Investment Service Directive)) and, subsequently, Art 19(1) Directive 2004/39/EC (hereinafter: 'MiFID I' ('Markets in Financial Instruments Directive I')).

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with their clients. In other words, the duty to act in accordance with the best interests of their clients (hereinafter also 'the best interest duty' or simply 'the duty') has direct application, thus grounding investment firms' liability even in cases where no *specific* rule of conduct is violated. Breach of the duty may trigger administrative sanctions (Art 70(3)(a)(x) MiFID II) or private remedies (Art 69(2) MiFID II).[2] Second, the duty is the backbone of the detailed conduct of business rules within the body of MiFID II and its implementing measures, playing a role in their interpretation. Such rules include those concerning conflicts of interest, staff remuneration practices (Arts 23 and 24(10)), limitations to inducements (Art 24(9)), and best execution (Art 27). Another specification of the duty is the requirement that firms apply a suitability or an appropriateness assessment before entering into a transaction with a client or on her behalf (Art 25(2) and (3)).

In this paper, we analyse the duty to act in the clients' best interest within the MiFID II framework, and illustrate its practical relevance by looking at its role in Italian financial markets law. More specifically, after recalling how the duty came to be an essential part of the ISD/MiFID framework (Part II), we first map how the duty is spelt out, at various junctures, in the Directive and highlight its functions (Part III). Next, we look into how the duty operates with reference to different investment services and activities covered by MiFID II, claiming that the duty is quite difficult to reconcile with services characterized by at-arms'-length relationships between the investment firm and the client (Part IV). Part V focuses on the use of the duty in the law in action of one member state, Italy, where retail investors have suffered from egregious cases of mis-selling of bonds issued by the banks acting as their investment services providers. Part VI concludes that the MiFID II regime falls short of clarifying with sufficient precision the implications of the best interest duty and, at least in the civil law jurisdiction we focus on (Italy), significantly expands the scope for judicial review of purely arms-length firms-clients relationships.

II. Antecedents of the Investment Firm's Duty to Act in the Best Interest of the Client

The best interest duty has a long history in common law countries, where it is often associated with fiduciary relationships. The duty has no comparable history in civil law countries such as Italy, although some functional equivalents exist.[3] In the common law tradition, the duty offers a highly protective standard

[2] See also Case C-604/11, *Genil 48 SL* and *Comercial Hostelera de Grandes Vinos SL* v *Bankinter SA* and *Banco Bilbao Vizcaya Argentaria SA*, Judgment of 30 May 2013, § 57, available at www.eur-lex.europa.eu (principles of equivalence and effectiveness bind Member States in the determination of private-law consequences of MiFID I violations).

[3] See Part III below.

as it implies the need to pursue the clients' interests above the fiduciaries',[4] if not also to act in the clients' sole interests.[5] Such an obligation has a pervasive role in ensuring investor protection in trust-based relationships.[6]

In the UK, the best interest duty was initially not conceived as a general principle applicable across the board of financial activities. In the wake of the 1986 financial markets reform, the duty was a distinguishing feature of independent activities were the service providers committed to providing independent advice covering a broad spectrum of products.[7] To the contrary, tied agents could also refer to products of their firm or marketing group alone.[8] For this reason, the 'best interest' requirement was a distinguishing feature of independent advisors, in line with their nature as investors' agents, with tied agents acting as salespersons on behalf of product manufacturers.[9] The 1986 'polarized' system was subsequently abandoned for a more homogeneous regulatory framework for investment advice,[10] and in 2004 the UK Financial Service Authority (FSA) (now Financial Conduct Authority (FCA)) Principles for Businesses adopted the current formulation that refers to the duty to pay 'due regard' to the interests of customers, and to treat them fairly.[11]

The best interest duty easily found its way through international recommendations and codifications of best practices as a principle applicable across the board. The 1990 IOSCO International Conduct of Business Principles – which were overall strongly influenced by the UK conduct of business rules[12] – recommended that firms should act 'with due skill, care and diligence, in the best interests of (their) customers and the integrity of the market'.[13] The Principles made no distinction between (independent) advice and pure sales, and this

[4] J. Benjamin, *Financial Law* (Oxford: Oxford University Press, 2007), 556-558.

[5] See T. Frankel, *Fiduciary Law* (Oxford: Oxford University Press, 2011), 149-152.

[6] A. Hudson, *The Law of Finance* (London: Sweet & Maxwell, 2nd ed, 2013), 299-300.

[7] J. Black, *Rules and Regulators* (Oxford: Oxford University Press, 1997), 140-143, 146, 149, 152.

[8] Securities and Investments Board (SIB), *Core Conduct of Business Rules,* Core Rule 17.

[9] N. Moloney, *How to Protect Investors. Lessons from the EC and the UK* (Cambridge: Cambridge University Press, 2010), 268.

[10] For a description see N. Moloney, n 9 above, 268; G. McMeel, 'Agency and the Retail Distribution of Financial Products', in D. Busch et al eds, *Agency Law in Commercial Practice* (Oxford: Oxford University Press, 2016), 182-183.

[11] UK *FCA Principles for Business*, Principle 6.

[12] G. Ferrarini, 'Towards a European Law of Investment Services and Institutions' 31 *Common Market Law Review*, 1283, 1304 (1994); M. Tison, 'Conduct of Business Rules and their Implementation in the EU Member States', in G. Ferrarini et al eds, *Capital Markets in the Age of the Euro* (Oxford: Oxford University Press, 2002), 68.

[13] IOSCO, *International Conduct of Business Principles* (1990), Principle 2. in the comment to their Principle 12, IOSCO's *Objectives and Principles of Securities Regulation* of 2003 (at 36) specified that firms should 'observe high standards of integrity and fair dealing and should act with due care and diligence in the best interests of (their) customers', which required market intermediaries to comply with standards for operational conduct that aim to protect the interests of clients. See now IOSCO, *Objectives and Principles of Securities Regulation* (2010), Principle 31.

approach was subsequently taken up in Art 11(1) ISD and, later on, in Art 19(1) MiFID I and Art 24(1) MiFID II.

III. The Duty to Act in the Best Interest of the Client in MiFID II: Use and Functions

According to Art 24(1),

> 'member states shall require that, when providing investment services or, where appropriate, ancillary services to clients, an investment firm act (...) *in accordance with* the best interests of its clients' (emphasis added).

Such a wording may seem to imply something less than a 'duty to act *in* the best interest of the client', but in fact the two can be regarded as one and the same, given their interchangeable use throughout MiFID II.

First, Art 24(2), para 2, requires investment firms 'to ensure that financial instruments are offered or recommended only when this is *in the interest of the client*'.[14] Second, Art 24(7)(b) clarifies that advice can be qualified as independent also when the investment firm receives

> '(m)inor nonmonetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's *duty to act in the best interest of the client*'.

The exact same wording can also be found in Art 24(8), which allows investment firms providing portfolio management services to accept inducements with the same characteristics. In addition, according to Art 24(10), an investment firm 'shall ensure that it does not remunerate or assess the performance of its staff in a way that conflicts with its *duty to act in the best interests of its clients*'.

Other provisions in the same Article rather repeat the wording of Art 24(1) ('in accordance with'), namely Art 24(9), para 1, sub (b), and para 3, and Art 24 (13)(d), addressing the conditions for receiving inducements.

Recital 71 confirms that the same concept underlies all these different wordings. Referring to Art 24(2), Recital 71, para 1 states that investment firms need to understand the features of the financial instruments they offer or recommend, as this enables them to comply with the duty to 'act *in accordance with* the best interest of their clients'. However, Art 24(2), as reported above, considers the same duty as a means 'to ensure that financial instruments are offered or recommended only when this is *in the interest* of the client'.[15]

[14] Emphasis added in this and the following quotations.

[15] Furthermore, the same Recital 71, para 2, refers to the duty to act 'in the interest of the client' as a perfect substitute of the duty to act 'in accordance with' the same interest referred to

Other references to Art 24(1) in MiFID II help identify the duty's scope. In some cases, such provisions clarify that Art 24 applies to a specific service, in others that it does not. For the sake of exposition, we can identify four different settings, depending on how the best interest duty combines with other general standards and with more detailed rules of conduct.

In the first setting, the best interest duty applies along with the companion Art 24(1) duty 'to act honestly, fairly and professionally' (hereinafter, 'the companion standards') and with more detailed conduct of business rules. For instance, Art 25(1) and (2) specify through detailed rules of conduct (further specified in Arts 54 ff Regulation (EU) 2017/565) how investment firms shall assess the suitability, or the appropriateness, of a service or a product, a conduct of business rule which is normally regarded as a specification of the best interest duty.[16] This regulatory technique raises the questions of whether and, if so, to what extent the best interest duty coexists with requirements established by detailed rules of conduct and therefore potentially adds on further duties to those stemming from such rules.

This uncertainty expands to the second setting, where the best interest duty – together with other general standards of conduct – applies, but one or more specific rules of conduct are explicitly waived. For example, the duty to assess the appropriateness of investment services and financial instruments is waived for the execution or reception and for transmission of trading orders concerning non-complex financial instruments, to the extent that such activities are performed at the initiative of the clients ('execution-only': Art 25(4) MiFID II). This means that investment firms do not have to obtain information on the (potential) clients' knowledge and experience, nor must they assess whether the envisaged investment services or products are appropriate for customers in the light of their knowledge and expertise. However, Art 25(4) does not exempt investment firms from any of Art 24(1) duties. Here, the question is how to combine the waiver of detailed rules of conduct with the enduring application of the best interest duty and its companion standards.

In a third setting, investment firms are exempted from the best interest duty, but not from the companion standards. This happens when investment firms perform straightforward execution or transmission of trading orders of – as well as when they deal on own account with – 'eligible counterparties' (a subset of professional clients: Art 30). In this case, MiFID II requires pre-contractual information and reports on the service provided and its costs (Art 24(4) and (5) and Art 25(6)), with the exclusion of any appropriateness assessment.[17] Eligible counterparties receiving those services are also protected by the companion

in the para 1.

[16] J.-P. Casey and K. Lannoo, *The MiFID Revolution* (Cambridge: Cambridge University Press, 2009), 46.

[17] Eligible counterparties may ask to be treated according to the ordinary investor protection regime (Art 30(2)).

standards and by the duty to provide clear and not misleading information, but they cannot rely on the best interest duty (Art 30(1)). This is a remarkable innovation in the MiFID II framework, as MiFID I exempted pure sales transactions with eligible counterparties from both the duty and the companion standards (Art 24 MiFID I). The inapplicability of the best interest duty reflects the fact that parties to an arm's-length transaction on the wholesale market do not normally protect each other's interests, unless otherwise agreed. However, MiFID II acknowledges that eligible counterparties may still expect investment firms to comply with companion standards.

Fourth, and finally, in some cases MiFID II excludes application of Art 24(1) in its entirety. For instance, non-discretionary crossing of buying and selling interests represents a key protective tool for multilateral trading facilities (MTFs) and regulated markets' members and participants when they route their orders to such trading venues: no space is left for assessing counterparties' interests with regard to transactions concluded on MTFs and regulated markets and therefore Art 24 does not apply (Arts 19(4) and 53(4)).[18]

To understand the functions of the duty in the MiFID framework, let us start by noticing that, while the best interest duty has its roots in the common law tradition as a key element of fiduciary relationships, other legal families have developed equivalent standards to buttress principal's protection from abusive agent's behaviours. In Italy, for instance, fair dealing and good faith principles, together with the duty to act professionally and with due care, represent the general standards underpinning contractual duties. They are not exclusive to contractual relationships based on agency (*causa mandati*), as they equally apply to transactional relationships, but when the principal is relying on an agent to promote and protect her interests they are interpreted so as to prevent the agent form pursuing her own interest to the detriment of the principal's position (Arts 1703 and 1710 Civil Code).[19]

MiFID II also refers to the fairness principle and to the professional standard (Art 24(1)), along with the best interest duty. This results in a juxtaposition of legal principles with different origins,[20] but all of them contribute to defining a

[18] Of course, the general Art 24(1) duties and their corollaries will continue to apply in the relationship between members and participants of trading venues on the one hand, and their respective clients whose orders are transmitted to the trading venue on the other (Arts 19(4) and 53(4) MiFID II). Note also that Art 24(1) applies, instead, to organized trading facilities (OTFs), which match orders on a discretionary basis (Art 20(6)).

[19] See eg L. Ferroni, 'Comment to Art 1703 Civil Code', in P. Perlingieri ed, *Codice civile commentato con la dottrina e la giurisprudenza* (Roma-Bologna: Edizioni Scientifiche Italiane and Zanichelli, 1991), 4.2, 1196. German law has also traditionally required agents in a contract concluded on a commission basis (*Kommissionvertrag*) to protect the principal's interest and to deliver her any asset obtained in the execution of the business commissioned (P. Mülbert, 'The Eclipse of Contract Law in the Investment Firm–Client Relationship: The Impact of the MiFID on the Law of Contract from a German Perspective', in G. Ferrarini and E. Wymeersch eds, *Investor Protection in Europe* (Oxford: Oxford University Press, 2006), 300).

[20] J. Benjamin, n 4 above, 568, 573 (fairness to consumers does not originate in English

broad range of protective standards that span, in a somewhat uneasy combination, from transactional to relationship contracts, and from common law to civil law traditions.

The best interest duty plays a key role in MiFID II's framework. First, it complements rules of conduct when these do not apply because of their limited scope. Second, the duty may justify pro-client interpretations, both by supervisors and courts, of the more specific MiFID II conduct of business rules, once again when narrow interpretations would not yield satisfactory results. Third, as an overarching principle in MiFID II, the duty provides guidance to EU policymakers in charge of drafting implementing regulations on specific matters the rationale of which is to ensure that the client's interest is protected, as is the case with cross-selling and inducements (Art 24(11), third subpara and 24(13)(d)).

More generally, and even in the silence of the Directive, the duty also applies to behaviour covered by specific conduct of business rules. In circumstances where substantial compliance with such rules is insufficient to ensure that the investor's interest is duly protected, subjective as this assessment may be, the duty itself kicks in and may represent a sufficient basis for administrative liability – and sometimes for civil liability as well, if national law so provides.[21]

IV. The Articulation of the Duty with Respect to Individual Services and Activities

Having set out the core functions of the best interest duty in the MiFID II framework, we are ready to move on to delineate how the duty operates with respect to individual investment services. To do so, we will distinguish between services based on a trust-like relationship and services *per se* entailing arm's-length transactions (hereinafter also arm's-length services). The analysis will confirm the intuition that the less an investment service or activity displays the features of a fiduciary relationship, the harder it is to gauge how the duty applies to it and, correspondingly, the more awkward the position of the investment firm if the duty is to be taken seriously.

The operation of the investment firm's best interest duty is unproblematic when it comes to the provision of investment advice and individual portfolio management, which are normally classified as fiduciary relationships.[22] The

case law and is inherently unclear and historically alien to English law).

[21] With specific reference to conflict of interest rules, see L. Enriques, 'Conflicts of Interests in Investment Services: The Price and Uncertain Impact of MiFID's Regulatory Framework', in G. Ferrarini and E. Wymeersch eds, n 19 above, 326 (complying with the specific conflict-of-interest rules will never be enough for firms, as these will always have to ensure that their clients are treated in accordance with their best interests).

[22] L.D. Smith, 'Can We Be Obliged to Be Selfless?', in A.S. Gold and P.B. Miller eds, *Philosophical Foundations of Fiduciary Law* (Oxford: Oxford University Press, 2014), 148 (advisory services, just like portfolio management, belong to fiduciary relationships).

problems come when applying the same duty to *per se* arm's-length (or transactional) relationships such as self-placement and dealing on one's own account. With regard to the latter, the question is to what extent Art 24(1) reflects an actual reliance on investment firms' commitment to act to the benefit of their counterparties in the same fashion as in a relationship of pure trust and confidence.[23] Another way to put it is that the identification of the client interest may vary depending on the service provided. Any interpretation and enforcement of the duty inevitably reflect an (often: implicit) assumption on what the interest to protect actually is. This can be the interest to buy a certain financial instrument or a certain investment service at the cheapest available price, or the interest to receive a suitable financial instrument, or to have the *most* suitable financial instrument within a range that can be, in turn, more or less broad depending on the circumstances, and so on. As the analysis that follows shows, regulators, courts and policymakers often refrain from openly clarifying what the specific interest at stake in each case is, or from providing guidance on how to identify it. This further contributes to making the best interest duty's effects less predictable.

1. The Duty, Fiduciary-Like Relationships, and the Boundaries of Investment Advice

Investment advice and discretionary portfolio management are, so to speak, the natural bedfellows of the best interest duty. The duty is in fact the typical element of these investment services by virtue of their fiduciary (or quasi-fiduciary) nature: if the investment firm provides investment advice or portfolio management, then the same firm has an unrestricted duty to serve the client's interest. However, this is not the end of the story, because the boundaries of investment advice are among the most debated issues in investment services regulation, and the best interest duty plays a key role in fostering investor protection in settings where 'advice' is provided that cannot be qualified as 'investment advice' (we may term this activity as 'non-investment-advice advice'). Indeed, the duty is sometimes invoked to expand protective measures that are typical of investment advice to border-line situations, including when evidence is lacking that the firm provided personal recommendations. The duty therefore contributes to reducing the risk that investment firms exploit loopholes in the MiFID framework to the clients' detriment, although this inevitably creates a risk of circularity, as the application of the duty partially contributes to determining the duty's own scope. In this Section, we first highlight some practical implications of the elusive definition of investment advice, which has likely facilitated some mis-selling scandals. We then move on to analyse how the best interest duty may prevent the circumvention of the investment advice regime, although at the cost of some legal uncertainty.

[23] A. Hudson, n 6 above, 299.

The protective role of the duty has significant practical implications, especially when the risk is high that investment firms drop implied recommendations in conjunction with the provision of investment services and activities such as placing of financial instruments and self-placement. Statements typically made in the sale activity do not expressly qualify a specific financial instrument as suitable to the investor's specific needs, but the investor may perceive them as (implied) recommendations because of the context in which they are made, or because she relies on the investment firm as someone acting as a fiduciary. Italy's experience with the mis-selling scandals that have occurred in recent years has raised concerns on the effects of the investment firms' selling pressure, and on their clients' ability to distinguish unadvised sales from investment advice.[24] Recent bank resolutions through bail-in[25] have shown that in a number of cases small investors' portfolios exposure to subordinated bonds would not have stood a suitability scrutiny, and the national supervisor (Consob) sanctioned the involved firms for violation of MiFID rules.[26] Clients' portfolio concentration was relatively high for some clients of the resolved banks,[27] and the problem is reportedly widespread among smaller banks in particular.[28] A portfolio with a high concentration of bonds issued by the client's bank can reasonably be viewed as indirect evidence that such bonds had been recommended to clients. Yet, mere recommendation may be insufficient to qualify the bank's interaction with the client as investment advice. Brokers' (required or spontaneous) communications with clients entails no presumption that they assess the suitability of the offered products. This distinguishes selling services coupled with

[24] In Italy, the traditionally high rate of direct investment by retail clients into (sovereign and non-sovereign) bonds facilitates mis-selling of fixed-income securities: see eg European Securities Markets Expert Group (ESME), *Non-Equity Market Transparency* (2007), 10 (in 2007, bonds comprised twenty-two point four per cent of total financial assets for Italian retail investors – compared with one point five per cent in the UK and six point nine per cent in the US – and were often held directly). Recurrent misselling scandals might have contributed to reducing households' willingness to invest in corporate and bank debt securities: Consob, *Statistical Bullettin* (2017), 14 (sovereign and corporate bonds amounted to more than twenty per cent of household financial wealth in 2007; the amount decreased to nine per cent in 2016, while the EU average was four per cent in the same year). Other countries with significant direct participation in bond markets are Germany and Belgium, while figures are lower for France: CEPR, *European Corporate Bond Markets: transparency, liquidity, efficiency*, 32 (2006).

[25] Arts 43 ff Directive 2014/59/UE (Bank Recovery and Resolution Directive (BRRD)); Art 27 Reg (EU) no 806/2014 ((Single Resolution Mechanism) SRM).

[26] See eg Sanction no 19935, 30 March 2017 (Banca Popolare di Vicenza Spa); Sanction no 20033, 14 June 2017 (Veneto Banca Spa); Sanction no 20067, 12 July 2017 (Banca Popolare dell'Etruria e del Lazio sc).

[27] For detailed data see G. Vegas, 'Indagine conoscitiva sulle condizioni del sistema bancario e finanziario italiano e la tutela del risparmio, anche con riferimento alla vigilanza, la risoluzione delle crisi e la garanzia dei depositi europee' (Intervento del Presidente Consob), 12 April 2016, available at https://tinyurl.com/ya5b7agc (last visited 25 November 2017).

[28] M. Longo, 'Bond bancari, quattro nodi da sciogliere', *Il Sole 24 Ore*, 13 December 2015, 7 (reporting that clients of small cooperative banks invest sixty-five per cent of their portfolios in financial instruments issued by their own bank).

generic advice from investment advice, although the previous analysis shows this distinction may be blurred in practice.

Remember that investment advice falls within the scope of investment services insofar as it consists in personal recommendations on specific financial instruments (Art 9 EU Commission Delegated Regulation (EU) 2017/565 – hereinafter 'Delegated Regulation'; previously Art 52 Directive 2006/73/EC). That definition is a key element in the MiFID II investor protection strategy because it brings along the duty to verify the suitability of prospective investments to clients' needs. This requires an assessment not only of the client's ability to understand the risks of the financial instrument, but also of the alignment between the client's investment needs and the financial instrument involved in the service. Recommendations falling outside the scope of investment advice because they are not personalised merely qualify as ancillary services (Annex I(B)(5) MiFID II), to which the suitability rule does not apply.

To qualify as investment advice, a recommendation has to be presented as suitable or based on a consideration of the clients' characteristics. Yet, under the MiFID I regime, the European Commission stated that a recommendation given to a client with no consideration for its suitability would be forbidden 'in the light of the fiduciary obligations firms are subject to' or, in other words, in light of the best interest duty.[29] This position aptly illustrates the role of the duty as a gap-filler: Art 24(1) is enlisted to prevent circumvention of the suitability test. As a result, investment firms cannot take advantage of the narrow definition of investment advice with a view to recommending unsuitable financial products when they purportedly perform pure brokerage or dealing activities.[30]

Furthermore, not even the provision of general advice on a generic kind of financial instrument would in principle amount to 'investment advice', even when that kind of financial instrument is presented as suitable. However, providing generic advice about a type of – as opposed to a specific – financial instrument does not remain completely unregulated. If an investment firm falsely presents that kind of generic advice as suitable to the client – or as based on the previous consideration of the client's characteristics – this will likely result in the violation of the best interest duty (Recital 15 Delegated Regulation; previously Recital 81 Directive 2006/73/EC). Once again, the duty fills the gaps left open by the inapplicability of the suitability test.

By the same token, Recitals 16 and 17 of the same Regulation expand conduct of business rules from the core investment service provided (eg order execution) to preliminary steps such as the provision of generic advice or of general recommendations through distribution channels. The extension of investor

[29] See EU Commission, 'Investment advice'—meaning of 'personal recommendation' Your Questions on Legislation, Question 158, 335, available at https://tinyurl.com/37z8th (last visited 25 November 2017).

[30] The question remains whether firms may be required, under the general Art 24(1) duties, to warn investors in case non-personalized advice is given (N. Moloney, n 9 above, 204).

protection beyond the limits of clear-cut rules of conduct in some critical circumstances such as placing of financial instrument heavily relies on the gap-filling function of the best interest duty. In particular, it prevents investment firms from easily circumventing those rules by steering their clients' investment decisions while providing non-advised services.

In Italy, Consob has coped with these issues by establishing a presumption that an investment firm provides investment advice unless it sticks to pre-defined standardized models when interacting with its clients. To the contrary, any free interaction between firms and customers in such critical circumstances may easily result in investment advice and could therefore expose firms not performing suitability tests to a high risk of noncompliance.[31]

That is a very sensitive area where EU policymakers are also struggling to find a proper regulatory balance. ESMA has recently stated that firms placing their own products are 'extremely likely' to provide personal recommendations (ie investment advice).[32] Empirical evidence shows that, in many countries,[33] demand for investment advice is positively related to financial knowledge, and that willingness to pay for financial advice is low, and Italy is no exception.[34] Consequently, blurring the boundaries of investment advice may induce investment firms to refrain from providing any kind of information to their clients, as this would entail the risk of being bound by higher standards of behaviour and of being exposed to the ensuing costs and liability risk. Such unintended consequences may make those clients who cannot afford, or fail to understand that it would be in their interest affording, the costs of fully fledged investment advice worse off.

To avoid this outcome, some Italian scholars and courts expand the scope of investment advice to the point that any sale activity is held to be accompanied by investment advice, with little or no room for proving the contrary.[35] Their interpretation is exclusively based upon the best interest duty and the need for protection underlying it. As we shall see more in detail in Part V, this strand of

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

[32] ESMA, 'MiFID practices for firms selling financial instruments subject to the BRRD resolution regime' (ESMA/2016/902) (2016) 8. See also ESMA, *MiFID* 'Suitability Requirements. Peer Review Report' (ESMA/2016/584) (2016) 7-8 (national competent authorities are often trying to clarify the boundary between information and advice).

[33] See eg A. Hackethal et al, 'Financial Advisors: A Case of Babysitters?' 36 *Journal of Banking and Finance*, 509 (2012) (for Germany); M.J. Collins, 'Financial Advice: A Substitute for Financial Literacy?' 21 *Financial Services Review*, 307 (2012) (for the United States); K. Bachmann and T. Hens, 'Investment Competence and Advice Seeking' 6 *Journal of Behavioral and Experimental Finance*, 27 (2015) (for Switzerland).

[34] M. Gentile et al, 'Financial Advice Seeking, Financial Knowledge and Overconfidence' *Quaderno di Finanza Consob no 83*, 30, 33 (2016).

[35] See eg D. Maffeis, 'La natura e la struttura dei contratti di investimento' *Rivista di diritto privato*, 63 (2009).

legal research and of case law claims that the investment firm's duty to pursue the client's interest transforms any arm's length sale into a fiduciary relationship, because the essence of the duty would not be compatible with purely transactional contracts.

On a purely factual basis, this interpretation fits with the widespread investment firms' practice to provide fee-free advice because of the households' notorious reluctance to pay to obtain personalized recommendations.[36] From a legal standpoint, the question remains whether the duty to act in the client's best interest is a sufficient basis for expanding the scope of investment advice so much that its provision to retail clients would become mandatory.

One reason to doubt it may be that in other circumstances European lawmakers have been explicit in mandating advice as a necessary safeguard for retail investor protection. Consider for instance the ELTIF Regulation (Regulation (EU) 2015/760 on European long-term investment funds), which requires that investment advice be performed not only by ELTIF asset managers marketing their own units to retail investors,[37] but also by investment firms distributing those units (Art 30). In the insurance sector, Directive (EU) 2016/97 (on insurance distribution – IDD) enables member states to mandate advice for the sales of any insurance product, or for certain types of insurance products (Art 22).[38]

2. The Duty and Its 'Odd Bedfellows': At-Arm's-Length Services

For services other than investment advice and discretionary portfolio management, operationalizing the best interest duty becomes even more challenging.

When providing pure execution and 'sale' services, such as brokerage, placement, self-placement, and dealing on own account, investment firms, which we refer to as broker-dealers in the following, do not take final decisions on client's investments, nor are they per se required to provide assistance in the assessment of the financial instrument that is being traded or sold, let alone of alternative investment choices. Their role in the process leading to the selection of the financial instrument purchase is passive when investors address them to trade products they have already identified as their target. In this scenario, firms just have to assess the client's ability to understand the financial risk involved and to provide information concerning the relevant investment service and

[36] FCA, 'Financial Advice Market Review. Final Report', 7 (2016); see also P. Giudici, 'Independent Financial Advice', in D. Busch and G. Ferrarini eds, *Regulation of the EU Financial Markets* (Oxford: Oxford University Press, 2017), 150 (households normally expect advice to be provided for free).

[37] This activity is not covered by MiFID II. For an analysis see M. Gargantini et al, 'Main Barriers to the Cross-Border Distribution of Investment Funds', in E. Avgouleas et al eds, *Capital Markets Union in Europe* (Oxford: Oxford University Press, forthcoming 2018).

[38] For the purpose of the IDD, advice entails a personalised recommendation explaining why a particular product would best meet the customer's demands and needs (Art 20(1) IDD).

financial instruments (Arts 24(3)-(5) and 25 MiFID II).

Broker-dealers may also take a more active stance, make potential customers aware that they have financial instruments for sale on their 'shelves', and inform them about such products' features, thus taking the initiative for the execution of trades with or on behalf of clients. This does not suffice in principle to trigger a borker-dealer's duty to assess whether the financial instruments and the investment services are suitable to the potential customers. However, the risk is high that promotional communications play out as concealed recommendations and, thus, as non-investment-advice advice. In Italy, concerns that investment firms may circumvent fiduciary-style obligations seem to underlie Consob's opinion, which we mentioned in Section IV.1, that investment firms should design standardized internal codes for business-to-client relationships and ensure their application by firms' staff. ESMA's statement on self-placement, equally mentioned in Section IV.1, reveals similar concerns.

In any event, no requirement exists that the products sold by broker-dealers comprise a wide enough selection of what is on the market or, in other words, that investment firms make any attempt to display all available products that would satisfy investors' needs. This is not even required from investment advisers, unless they present themselves on the market as independent advisers (Art 24(7) MiFID II).

While the best interest duty entails no obligation to offer a minimum range of financial instruments, it still has some implications that are hard to reconcile with the very nature of sales activities. This is the case, for instance, with the no-profit rule, which prevents agents from taking advantage of their position by extracting wealth from the activities they perform for the beneficiary without her authorization (as is the case with incentive-based compensation arrangements).[39]

Because the typical remuneration system for investment firms operating as principals, rather than as their customers' agents, consists of mark-ups and mark-downs[40] – as opposed to commissions and fees – dealers are inevitably earning from spreads on market prices. This may produce an inherent conflict of interest only to the extent that the dealer is subject to duties that go beyond what is expected from a mere buyer or seller; in any contract, one of the parties has an incentive to appropriate the maximum possible part of the counterparty's reservation price, but qualifying this as a form of misappropriation would simply place dealers out of business.

Scholars that have approached the problem at the European level often exclude that the MiFID (II) conflict of interest regime encompasses situations

[39] R.H. Sitkoff, 'The Economic Structure of Fiduciary Law' 91 *Boston University Law Review*, 1039, 1041 (2011) (incentive-based compensation arrangements normally used to reduce – although not eliminate – agency problems).

[40] SEC, *Study on Investment Advisers and Broker-Dealers* (2011), 10-11.

where contractual counterparties, which are not linked by any principal–agent relationship, simply aim to maximize their own gains in a market-based transaction.[41] The general understanding is similar in Italy, but an increasingly accepted view expands the scope of the conflict of interest regime so as to include investment firms' own interests in proprietary trading.[42] It does so by relying on the flexibility of the best interest duty, which seems to offer a ready-to-use tool to address such situations by introducing fiduciary-style elements in transactional relationships. Therefore, it is convenient to test the longstanding narrower view of conflicts of interest against the new MiFID II framework, and against the most recent supervisory approach in the enforcement of the MiFID I regime. We will perform this exercise using three examples: contracts for difference (CfDs – analysed in this Section), product governance (Section IV.3), and self-placement (Section IV.4). As we shall see, the results of the test are hardly conclusive, but they suffice to call the traditional view into question.

Consider first OTC derivatives. Investment firms offering derivative contracts and acting at the same time as their clients' counterparties inevitably make (lose) money when their clients lose (make) money. An ESMA Q&A document has stressed this divergence between the investment firms' and the clients' interests in the context of CfDs and other complex speculative products such as binary options and rolling spot forex. In the Authority's view, those contracts entail a conflict of interest that cannot be adequately managed, inherent as it is to the investment firms' proprietary position, unless investment firms hedge, in whole or in part, their client orders. As a consequence, ESMA believes that the incentives to profit from investors' losses can by no means comply with the best interest duty, and that the offer of CfDs and other speculative products to retail clients should therefore be avoided altogether.[43]

The Q&A document therefore adopts a very broad notion of conflict of interest, which seems at odds with the traditional idea that entering a contract as a principal does not imply, in and of itself, a conflict of interest. The MiFID II regime on product governance would seem to follow, instead, a narrower view in the identification of the relevant conflicts, as the next Section will show.

3. Product Governance and Complex Financial Products

Not only does MiFID II strengthen rules concerning firm-client relationships,

[41] C. Kumpan and P. Leyens, 'Conflicts of Interest of Financial Intermediaries' 5 *European Company and Financial Law Review*, 72, 79 (2008). See also S. Grundmann and P. Hacker, 'Conflicts of interest', in D. Busch and G. Ferrarini eds, n 36 above, 166-167 (only situations where the power to influence the interest of a principal is entrusted to the counterparty and is accompanied by a consideration are relevant for MiFID I and II regime on conflicts of interest). See also Section IV.4 below for specific issues concerning self-placement.

[42] See Part V below.

[43] See ESMA, *Questions and Answers relating to the provision of CFDs and other speculative products to retail investors under MiFID* (ESMA/2016/590), 18, 20 (2016).

but it also sets specific obligations to consider clients' interests in manufacturing[44] and distribution activities (Art 24(2); Arts 9 and 10 Delegated Directive (EU) 2017/593).[45] These obligations also apply when no suitability assessment is required,[46] as they also include mere securities offers besides recommendations. ESMA has clarified that investment firms are expected to define both a positive target market and a negative one. While the first one refers to clients for whom the product involved is ideally conceived, the negative target market identifies the set of clients whose features are incompatible with the product.[47] Exclusion of a client from a certain product's positive target market does not prevent investment firms from selling that product to that client, provided that all the applicable safeguards – such as suitability and appropriateness tests and conflict of interest management – are respected. However, this requires justification on the basis of the specific facts of the case, and documentation of the reasons for the deviation. Not even inclusion of a customer in the negative target market prevents the sale, but ESMA expects this to be a rare occurrence and requires strengthened justification.[48]

By addressing the organizational side of potential misbehaviours, MiFID II leverages on firms' superior information,[49] as a complement to directly regulating their conduct. This focus on upstream elements de facto broadens the scope of the (quasi-fiduciary) suitability test, and indirectly makes the appropriateness scrutiny provided downstream stricter.

Rules setting out obligations to consider clients' interests in manufacturing and distribution activities may also result in a selling ban when the best interest duty would be impossible to abide by for any possible target. In ESMA's view, when this is the case, national competent authorities 'should monitor that firms do not offer advice on that envisaged product, or sell it at all':[50] the reference to mere selling activities shows how remarkable the effects of fiduciary-like duties can be when they apply to arm's-length transactions. While some competent authorities had already restricted the marketing of certain complex financial

[44] For further specifications see ESMA, *Structured Retail Products: Good practices for product governance arrangements* (ESMA/2014/332) (2014).

[45] Art 16(3) requires identification of a target market of end clients and consideration of all risks relevant to such a target when manufacturing financial instruments; the distribution strategy shall be coherent with the target, too. Art 24(2) reinforces this duty by ensuring that manufacturing and distribution of financial instruments meet the target market's needs.

[46] Art 16(3), para 7, MiFID II clarifies that rules on product manufacturing and distribution apply without prejudice to requirements concerning appropriateness. See also N. Moloney, *EU Securities and Financial Markets Regulation* (Oxford: Oxford University Press, 3rd ed, 2014), 800.

[47] ESMA, Guidelines on MiFID II product governance requirements (ESMA35-43-620), 2 June 2017.

[48] ibid 46, §§ 70-1.

[49] See J. Armour et al, *Principles of Financial Regulation* (Oxford: Oxford University Press, 2016), 266.

[50] ESMA, *MiFID practices for firms selling complex products* (ESMA/2014/146) (2014), 3.

instruments at national level long before ESMA's opinion was released,[51] this opinion facilitates the adoption of similar prohibitions by other authorities.

In Italy, Consob has recommended that certain 'complex financial products' not be sold to retail customers.[52] As the provision of arm's-length investment services and activities creates frictions with the best interest duty, one can easily see how a strict interpretation of this general standard of behaviour may yield results comparable to product intervention, with the advantage that these results are attained without the need to take the procedural steps posited by rules on product intervention (Arts 40 ff MiFIR).

How far this approach will possibly go depends in part, once again, on the extent to which the investment firm's own interest will be deemed in contrast with – rather than in mere opposition to – the client's interest the firm should pursue. The product governance regime delineated in the Delegated Directive requires (member states and, hence) investment firms to consider 'potential conflicts of interests' when they manufacture a product. In this respect, firms have to take into account 'whether the financial instrument creates a situation where end clients may be adversely affected if they take: (a) an exposure opposite to the one previously held by the firm itself; or (b) an exposure opposite to the one that the firm wants to hold after the sale of the product' (Art 9).

Remarkably, the rule does not include, among the sources of conflicts of interest, the manufacturer's exposure to the financial product it manufactures. If the manufacturer retains a long (short) position in the product, it will gain (lose) from an increase (decrease) of the underlying assets, while the final investor will symmetrically lose (gain) money. Depending on the terms and conditions of the contract, the manufacturer may therefore face a conflict comparable to the conflict ESMA deems relevant in its opinion on CfDs (Section IV.2). However, a manufacturer's proprietary position in the very same contract it has engineered does not seem to entail, in and of itself, a relevant conflict of interest under Art 9 Delegated Directive. The regulatory approach underlying the conflict of interest regime in the context of product governance is therefore in line with the traditional view we described in Section IV.2, a noteworthy difference from the supervisory approach concerning CfDs. In the next Section, we will examine how the conflict of interest regime applies to proprietary trading, and especially self-placement, under Art 23 MiFID II and its implementing rules.

4. Proprietary Trading and Self-Placement

[51] For a summary of national measures see N. Moloney, n 46 above, 825-826.

[52] Consob, Communication 97996, 22 December 2014, 5 (also establishing some specific procedural guarantees in case such complex products are sold notwithstanding Consob's recommendation. Among the complex products to which the recommendation applies are asset-backed securities (ABS), CoCo bonds, financial instruments qualifying as additional tier 1 capital as per Art 52 Reg (EU) no 575/2013 (CRR), credit linked notes, and derivatives not negotiated in a trading venue and not held for hedging purposes).

Under the MiFID I regime, the treatment of direct placement of proprietary financial instruments (self-placement)[53] by investment firms was uncertain. In Italy, the traditional view was that direct placement by issuers – whether corporate or financial institutions – did not fall within the scope of MiFID-regulated activities, because the ability to raise capital that is inherent to the very essence of every company inevitably requires direct contacts with multiple potential investors, and no indication exists that such day-to-day contacts qualify as reserved activities.[54] The law was thus amended in 2005 to make MiFID I conduct of business rules applicable to self-placement by banks and insurance companies.[55]

In MiFID II, self-placement expressly qualifies as an investment service: order execution now includes 'the conclusion of agreements to sell financial instruments issued by an investment firm or a credit institution at the moment of their issuance' (Art 4(1)(5)). This broadened definition brings new activities into the scope of EU rules, thereby extending the scope of the best interest duty to areas where investment firms' duties may uneasily combine with such firms' interests as issuers or as contractual counterparties in a derivative contract.

How much the inclusion of self-placement into MiFID II scope will strengthen investor protection remains to be seen. We offer two examples to illustrate the current uncertainty.

First, what is the reach of the broadened definition of order execution? Some commentators have submitted that the new definition does not include primary market transactions where issuers are not acting in their capacity as investment firms, but just as mere contractual counterparties in arm's-length transactions where no relationship with a 'client' exists.[56] This opinion is based on the distinction between the provision of investment *services* (in favour of a client) and the performance of an investment *activity* (with a counterparty not receiving any service),[57] a distinction which the wording of some of the provisions outlining conduct of business rules would seem to justify: some key MiFID II provisions setting forth rules of conduct explicitly refer, just like MiFID I, to the provision of investment (and in some cases also ancillary) *services*, but not to

[53] The term 'self-placement' was first used in the 2012 Advice of the Securities and Markets Stakeholder Group on remuneration policies and practices (ESMA/2012/SMSG/69), 5 (2012). See P.-H. Cònac, 'L'auto-placement d'instrument financiers par l'établissements bancaires et la protectiòn des investisseurs par l'ESMA', in F. Ferrand ed, *Liber amicorum Blanche Sousi* (Paris: RDÈdition, 2016), 369, 372.

[54] See Consob, Communication DAL/RM/96011036, 11 December 1996; Consob, Deliberation no DIN/58349, 29 July 2000; see also Consob, Deliberation no 18696, 12 November 2013 (Deliberation no DIN/58349 still applicable).

[55] Art 25-II Consolidated Law on Finance.

[56] See K. Lieverse, 'The Scope of MiFID II', in D. Busch and G. Ferrarini eds, n 36 above, 29-30.

[57] ibid.

the performance of investment *activities*.[58]

Yet, the European Commission has adopted a different interpretation with regard to MiFID I, on the basis that the Directive provided no clear criterion for distinguishing 'between cases where a service is being provided to a client and (...) those where an activity is simply being carried on *with* a person who is not a client'.[59] Therefore, every person entering into a transaction with an investment firm should be regarded either as an eligible counterparty – and hence as a client, as per Recital 40 MiFID I, now Recital 109 MiFID II[60] – or as a professional or retail client. The transaction would hence necessarily be subject to MiFID conduct of business rules (Art 19 MiFID I, now Art 24 MiFID II), with the limited exception of best execution in transactions that are not carried out on behalf a client.

Nothing seems to have changed with MiFID II, including the uncertainty surrounding the European Commission's interpretation. On the one hand, the exemption from MiFID II rules for persons dealing on own account applies to the extent that such persons do not provide any 'other' investment service or perform any 'other' investment activity, which suggests that dealing on own account may constitute both a service and an activity (Art 2(1)(2)). And the same exemption does not include dealing on own account when executing client orders (Art 2(1)(d)(iv)). But, on the other hand, it is not clear whether pure dealing on own account qualifies as a service or an activity in the taxonomy of MiFID II.[61] Similarly, Art 33 Delegated Regulation would seem to

[58] See MiFID II, Art 24 (1), (2), (4), (5), (6), (9), (10), and (11) on general principles; Art 25 (1), (2), (3), (4), and (7) on the appropriateness test; Art 29(3) on tied agents.

[59] EU Commission, *Answers to CESR scope issues under MiFID and the implementing directive* (Working Document ESC-07-2007) (2007). See also P. Nelson, *Capital Markets Law and Compliance, The Implications of MiFID* (Cambridge: Cambridge University Press, 2008), 228-229 (FSA initially excluded application of MiFID I to 'non-clients', which was clearly not the intention of MiFID I, and later on tried to stress that in some circumstances client orders are missing, but the EU Commission 'killed the argument'). See also R. Kent et al, 'Conduct of Business', in R. Fox and B. Kingsley eds, *A Practitioner's Guide to the UK Financial Services Rulebook* (London: Sweet & Maxwell, 2013), 218-219 (EU Commission's restrictive position on the possibility to exclude investor protection on the basis that no client relationship exists suggests erring on the side of caution when excluding that a counterparty qualifies as a 'client').

[60] See also M. Kruithof, 'A Differentiated Approach to Client Protection: The Example of MiFID', in S. Grundmann and Y. Atamer eds, *Financial Services, Financial Crises and General European Contract Law. Failure and Challenges of Contracting* (Alphen aan Den Rijn: Kluwer Law International, 2011), 142-144 (in MiFID I regime, arm's-length transactions between eligible counterparties are regarded as services even if this would not be the case in day-to-day language, so that such transactions are subject to MiFID I conduct of business rules unless these are explicitly made inapplicable).

[61] At the same time, exemptions from application of conduct of business rules for dealing on own account with eligible counterparties can only make sense if such rules would otherwise be applicable (Art 30). See however D. Busch, 'Agency and Principal Dealing under the MiFID I and MiFID II', in D. Busch and G. Ferrarini eds, n 36 above, 151, 153-154, 159 (dealing on own account not performed *vis-à-vis* clients, hence not subject to client classification duties and to

allow a differentiation between investment services and investment activities because, in line with Art 23 MiFID II, it only links the conflict of interest duties to the provision of investment services, while only mentioning investment activities among the sources of potential conflicts. One could argue that MiFID II confines the scope of application of the conflict of interest regime to investment services alone.

In its consultation paper on the technical advice to be delivered to the Commission in view of the adoption of MiFID II Level 2 measures, ESMA stressed that self-placement inevitably entails conflicts of interest for banks, and suggested that procedures adopted for their identification and management

> 'may include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients'.[62]

Upon the suggestion of the Securities and Markets Stakeholders Group, the requirement was strengthened in ESMA's final technical advice, subsequently reflected by Art 41(2) Delegated Regulation, according to which investment firms' procedures on conflicts of interest must include the option of refraining from engaging in self-placement.[63]

This is a remarkable twist in the European regime on conflicts of interest. Under MiFID I the general approach was rather based on conflict management and, in case this proved unable to prevent the risk of damaging customers, on disclosure. Now, in the context of self-placement, that risk leads to the duty not to enter the contract. What remains unclear, however, is when exactly this new regime would apply. In particular, one may wonder how the prohibition adds on other safeguards, such as the appropriateness test. If properly performed, this and other protective measures should suffice to prevent adverse effects on clients: no product should be sold unless the investor can understand its risks (including its possible adverse effects). Hence, a possible reading of Art 41(2) may be that the conflict of interest should prevent self-placement when it is so pervasive as to jeopardise investment firms' compliance with other protective measures. Of course, one may doubt that an investment firm ready to breach the appropriateness test and other protective measures would be eager to comply with this new prohibition. However, the clear-cut nature of the Art 41(2) prohibition may make this new rule more easily enforceable than other protective measures such as the appropriateness test, the inherently nuanced nature of which makes violations more difficult to demonstrate.

conduct of business rules – with the possible exception of fair dealing – including on conflict of interest).

[62] ESMA, *Consultation Paper. MiFID II/MiFIR* (ESMA/2014/549), 82-83 and 86 (2014).

[63] ESMA, n 32 above, 86 ('may' replaced with 'must'). See P.-H. Cònac, n 53 above, 373.

V. The Italian Private Case Law on the Best Interest Duty

In the light of the many uncertainties that affect the regulatory framework on investment services, Italian private case law offers a fruitful perspective on many implications of the best interest duty. Even before *Genil* and Art 69 MiFID II, there was little doubt in Italy that breaching conduct of business rules could trigger private remedies.[64]

In this Part, we illustrate the expanding role of the best interest duty in a civil law jurisdiction by looking at how Italian courts (and legal scholars) have used it to expand the avenues for granting redress to aggrieved bank clients.

To start with, Italian courts often state that the best interest duty and its companion standards are a specification of general contractual law duties, such as the duty to act fairly and in good faith. While general MiFID (II) standards are therefore fully compatible with contractual law, courts also stress that they add further protection to investment services clients, because they deviate from the traditional civil law approach that tends to consider contractual parties on an equal footing.[65] The best interest duty and its companion standards, instead, enhance protection for one side of the contract, thus making the contractual regime asymmetric. As a consequence, those standards are normally used to interpret the Italian contracts law general duty to act fairly and in good faith in the execution of contracts in a particularly demanding way for investment firms,[66] so as to compensate their inherently higher contractual power vis-à-vis less sophisticated counterparties.

Furthermore, under Italian law, contracts are null and void in a number of cases. Chief among them, at least for its open-endedness, is the case when a contract is in violation of mandatory provisions that encroach upon the contents of contractual obligations (Art 1418, para 1, Civil Code). The best interest duty is a mandatory rule, and courts have made reference to its breach in qualifying a contract as null and void.[67]

An additional case of contract invalidity is when the contract lacks consideration (*causa*) or has an illicit purpose (*causa illecita*: Arts 1325, 1343 and 1418, para 2, Civil Code). While under the principle of contractual freedom parties can freely enter any type of contract, this is not valid – for lack of consideration – if it aims to fulfil an economic interest the court deem as

[64] For an overview see F. Della Negra, 'The Private Enforcement of the MiFID Conduct of Business Rules. An Overview of the Italian and Spanish Experience' 10 *European Review of Contract Law*, 571, 584-586 (2014); F. Rossi and M. Garavelli, 'Italy', in D. Busch and C. Van Dam eds, *A Bank's Duty of Care* (Oxford: Hart Publishing, 2017), 135.

[65] Corte di Cassazione 25 June 2008 no 17340, *Foro italiano*, I, 1851 (2009).

[66] F. Rossi and M. Garavelli, n 64 above 130-140.

[67] Corte di Cassazione 19 December 2007 no 26724, *Banca, borsa titoli di credito*, I, 686 (2010). If, instead, the violation concerns conduct rules that do not make the contractual content *per se* illegal but simply deviate from the required behavioural standards, the investment firm's liability will lead to compensation but the contract will remain valid.

undeserving of protection in the light of the general principles of the law (Art 1322 Civil Code) or when the exchange itself is contrary to mandatory rules.

Some courts have used these provisions on contracts' consideration, in connection with the best interest duty, to declare certain contracts between an investment firm and a client null and void. To do so, they have assessed the balance between parties' expected profits from the contract, and have deemed contracts that were disproportionately disadvantageous for clients to be in breach of the best interest duty – and therefore null and void – because the exchange was contrary to a mandatory provision. While the results of this assessment may be similar among different decisions, courts adopt various strategies to reach comparable conclusions. We will now briefly analyse the courts' most common kinds of reasoning.

Italian courts often assess whether derivative contracts lack consideration, typically for over-the-counter derivatives such as an interest rate swap (IRS). When performing this exercise, courts choose from a broad range of legal doctrines. To summarise a plentiful case law, we can identify two lines of reasoning. The first one focuses on the mismatch between the declared intent of the weak party and the actual structure of the derivative contract. The second gauges the balance of contractual parties' obligations in the light of the probability distribution of its potential outcomes, and labels as 'irrational' those contracts that allocate risks in such a way as to justify the conclusion that there should be no possible reason for the weak party to enter them.

The two lines may of course combine. While courts often invoke the lack of a true hedging function as a sufficient basis for nullity on a stand-alone basis, they mostly refer to lack of a rational allocation of risks in combination with the first one.

Let us analyse the case law that focuses on the client hedging needs, first. Courts sometimes assess whether banks and investment firms structure derivative contracts in a way that actually meets their clients' needs, and declare those contracts null and void (or, in any event, unable to have legal effects) when this is not the case. The legal basis is that this mismatch implies a violation of the duty to act in the client's best interest; as a consequence, the contract would be illicit. As we said, this is most often to be seen in cases concerning OTC derivative contracts such as IRS.

The judicial analysis regularly admits that derivatives contracts, despite their potential for serious exposures, are in principle fully compatible with the law, and so are the reasons why each of the parties may enter these contracts (hedging, speculation, and arbitrage). For instance, it is widely accepted that an IRS entails a reciprocal exchange of cash flows, each calculated according to different criteria. Nor is it debated that the customer (either a professional or a retail client) may have no other reason to purchase an IRS than speculation. At this point, however, some courts review the actual content of the contract,

including the respective positions of the parties, in the light of the interests the parties declared when they entered the contract. For instance, the Court of Cassation has stated that an IRS is null and void when, albeit aimed at hedging the interest rate risk the customer is subject to, it does not exactly match each element of the underlying exposure of that client.[68] In the Court's reasoning, while the overall effect of the contract was therefore in line with its declared aims, the possibility that a mismatch had occurred rendered the contract unable to satisfy the client's best interest in all circumstances.

In a similar vein, the Court of Cassation has ruled that no legal effect could attach, for lack of consideration, to an investment contract whereby the client had borrowed money from the bank with the duty to invest it in financial products that the bank itself could freely determine. The only restriction the bank faced when selecting the portfolio was that the choice would protect the client's interest to enjoy a retirement plan.[69] Deeming the actual composition of the portfolio at odds with the declared interest of the client, the Court declared the contract unenforceable for the bank, as it was in breach of Art 1322 Civil Code.

Decisions focussing on the contracts' lack of rationality – the second strand of decisions – reach a similar outcome with a different line of reasoning, but they still invoke the duty to act in the client's best interest as the legal basis for quashing the IRS contract. Along with some legal scholars' positions, these decisions assess whether the contractual equilibrium allocates the aleatory returns between the two parties of the derivative in a rational manner.[70] Consequently, the contract is declared null and void when the client (whether retail or professional) has no access to the information he or she needs to understand the allocation of risks. This information, which some decisions considered as an essential element of the derivative contract that the investment firm has to share with the client, goes beyond what the MiFID II regime requires (Art 24). It includes the IRS fair value at the time the client enters the derivative (possibly calculated with a mark-to-market assessment), with a view to clarifying the hidden cost resulting from the difference between that value and the price of the contract, and the probabilistic scenarios associated with the contractual conditions.[71]

The theoretical underpinning of this assessment lies with a broad interpretation of the duty to act in the client's best interest. Decisions belonging to this group often consider such duty as a symptom of the very nature of the relationship between banks and their customers. The duty reflects – so the reasoning goes –

[68] Corte di Cassazione 31 July 2017 no 19013, available at www.ilcaso.it.

[69] Corte di Cassazione 30 September 2015 no 19559, *Banca, borsa, titoli di credito*, II, 137 (2016).

[70] Corte d'Appello di Milano 13 September 2013 no 3459, *Banca, borsa, titoli di credito*, II, 278 (2014); Corte d'Appello di Milano 9 March 2016 no 3070, available at www.dirittobancario.it.

[71] In its Communication no 97996 n 52 above, Consob also required disclosure of the fair value and of the costs (mark-up) included in the price of complex financial products.

that there can be no *caveat emptor* between banks and their clients. Irrespective of the specific investment service or activity performed, investment firms are under the obligation to assist their clients because of the duty to act in their best interest. This includes the duty to give suitable recommendations to the customer, even in the absence of any agreement to provide investment advice. In other words, all the agreements subject to the duty to act in the client's interest fall into the scope of fiduciary or quasi-fiduciary relationships (*causa mandati*), while no space is left at all for pure sales (*causa vendendi*) unaccompanied by advice.

VI. Conclusion

MiFID II confirms, in line with its predecessors, that investment firms shall act in accordance with their clients' best interest. Investment firms may be held liable in case they do not comply with this overarching fiduciary-style duty. In the preceding Parts, we have highlighted how the best interest rule set forth by the MiFID II regime applies across the board, encompassing situations where such a duty does not easily fit with the nature of the activities performed. Fiduciary-style duties are a well-grounded regulatory tool to reduce the risk of opportunistic behaviour in contractual relationships, such as portfolio management and investment advice, characterized by information asymmetries, as they curb agents' incentives to take advantage of their principals' reduced ability to monitor agents' performance.[72] To the contrary, the fiduciary paradigm is hard to reconcile with the very nature of arm's-length services.

The Italian case law offers a good opportunity to observe the duty's implications for investor protection. Contrary to what happens in some other European countries, Italian courts regularly attach private law consequences to MiFID (II) violations, so that disgruntled investors (successfully) bring a considerable amount of disputes before courts. Furthermore, investors willing to obtain protection before Italian courts typically invoke, besides violation of specific conduct of business rule, that investment firms breached the general behavioural standards they are bound to – chief among them the best interest duty. This creates a unique and broad sample to test the functions and the contents of the duty. Italian courts, on their turn, do not refrain from stretching the duty's implications in ways that might not be familiar to other jurisdictions. The duty sometimes provides the legal basis for assessing the contractual equilibrium, and for quashing the contract under a variety of doctrines. Courts have done so based on the conclusion that the parties' obligations are so unbalanced that no rational client would have entered the contract, had she known the probability distribution of the payoffs. By the same token, courts have declared contracts null and void when their payoffs do not match the

[72] R.H. Sitkoff, n 39 above, 1042-1045.

declared hedging purposes of the client. In all these circumstances, courts deem contracts unable to pursue the client's best interest.

In this concluding Part, we show how the MiFID II regime falls short of clarifying with sufficient precision the implications of the best interest duty. First, it is not clear what the duty's implications are when this applies to transaction that are – or have traditionally been interpreted as – performed at arm's length. Second, the interaction is sometimes uneasy between the duty, which is a general standard, and conduct of business rules, which set more detailed behavioural requirements. These problematic interactions – one between the duty and transactional relationships, the other between the duty and rules of conduct – may lead to divergent interpretations of the duty's implications and may hinder harmonisation, thus resulting in reduced legal certainty for investment firms and investors alike: market participants, supervisors, and courts may in fact interpret the duty in different ways. At the two extremes, the duty may be regarded as a generic reference to average market practices or, on the opposite side, as a pervasive tool that may lead to reclassify all investment contracts as fiduciary relationships.

As we have seen, the best interest duty fits some investment firms' activities so little that, under the current regime as interpreted by ESMA, some of these activities cannot be performed at all, lest the duty is breached.[73] In other words, the best interest duty rule may act as an indirect ban on some services or product sales. Whether such services are only high-risk from the clients' perspective or inherently abusive is key to understand the impact of the best interest duty on the market for investment services. The MiFID II system provides for a special product intervention regime with a view to tackling significant investor-protection concerns, but the best interest duty may achieve the same purpose by virtue of its broad scope and its inherent flexibility. The experience with the CfDs demonstrates that the duty may be used to justify an outright ban, possibly as a prelude to a full-blown product ban based on the product intervention regime.[74]

Broad principles setting fiduciary-style duties are a key tool for effective enforcement in critical situations where detailed rules of conduct leave loopholes that investment firms can exploit to the detriment of their clients. MiFID II specific conduct of business rules are not immune to that risk. Broad principles such as the best interest duty and its companion standards therefore play an

[73] This may be the case with complex products that cannot meet the best interests of their clients or the risk of which cannot be assessed for lack of sufficient information (n 51 above and accompanying text); similarly, investment firms selling CFDs or complex derivative financial instruments would breach their (retail) clients' best interest unless they hedge, at least in part, their exposure (n 44 above and accompanying text).

[74] See ESMA, Statement on preparatory work of the European Securities and Markets Authority in relation to CFDs, binary options and other speculative products (ESMA35-36-885), 29 June 2017 (anticipating possible product intervention measures on CfDs because of insufficient supervisor measures).

important role in ensuring a reasonable regulatory equilibrium. To avoid the risk that invoking general standards may lead to over-enforcement, fiduciary-style obligations need to be interpreted in a flexible manner,[75] and in the light of the nature of the service provided.[76] While increased protection of clients' best interest makes perfect sense when a fiduciary relationship between clients and investment firms combines with personalized recommendations of firms' own products, at the other extreme purely transactional relationships taking place in the context of own-account dealing do not warrant such intense protections. In this second scenario, the best interest duty is sometimes implemented, at national level, as a requirement that investment firms pay due regard to their clients' interests, rather than focusing exclusively on them.[77] The MiFID II principle that firms shall act 'in accordance with' the client's best interest would seem flexible enough to be compatible with such interpretation, when the very nature of the relationship between firms and their clients has no fiduciary component.

The best interest duty is further specified by more detailed provisions within the body of MiFID II, including rules concerning the management of conflicts of interest and inducements, best execution, and suitability or appropriateness of financial instruments and investment services. The combination of detailed provisions setting out conduct of business rules and of more general standards of behaviour has many advantages, as it can ensure that firms are subject to a regime that is clear and, at the same time, flexible enough to address *ex post* shortcomings that the lawmaker cannot possibly predict because of limited rationality in forecasting future states of the world.[78] However, this regulatory technique requires careful coordination between rules and standards at the enforcement stage, in order to avoid conflicts and suboptimal outcomes.[79]

MiFID II falls short of clarifying how the two regulatory layers interact when the specific conduct of business rules do not apply because the parties decide to deviate from them. For instance, MiFID II allows[80] contracting parties,

[75] N. Moloney, n 9 above, 218 (reasonableness criteria needed to countervail excessive discretion in *ex post* review).

[76] Cf R.H. Sitkoff, n 39 above, 1043-1045 (principles should not be considered in isolation. Duty of care establishes a reasonableness standard that 'is informed by industry norms and practices').

[77] J. Benjamin, n 4 above, 558, 572, 579 (under UK FSA's Principles for Business – Principle 6 – firms 'must pay *due regard* to the interests of customers, and treat them *fairly*, ie balance the interests of the clients with their own, rather than always and loyally promote the clients' interests above their own' (emphasis in original)).

[78] J.J. Park, 'The Competing Paradigms of Securities Regulation' 57 *Duke Law Journal* 625, 640 (2007) (rules are promulgated *ex ante*, while principles are defined *ex post*).

[79] Cf J. Benjamin, n 4 above, 556-561, 580-583 (highlighting risk of uncertainty inherent to widespread reliance on equity and standards as opposed to rules and the common law).

[80] A different problem is whether national law can allow contractual opt-out even in other circumstances. The question is normally answered in the negative, although with some uncertainties in some jurisdictions: see D. Busch, 'Why MiFID Matters to Private Law: The

including weaker retail clients, to deviate from some core specific conduct of business rules when investment firms are operating within the execution-only regime, that is, as mere order-takers to the benefit of customers that are only looking for execution services at a low cost. Here, only conflict-of-interest provisions remain in place (Art 25(4)(d) MiFID II). In such circumstances, the duty to take all reasonable steps to obtain the best possible result in the execution of clients' orders (Art 27 MiFID II) buttresses investment firms' duty of care in the provision of the trading service, while no explicit obligation exists to ensure that the traded financial instruments are appropriate for the ordering customer. However, the general standards set forth in Art 24(1) MiFID II remain applicable even in the execution-only regime, and this leads to uncertainties. In particular, it is unclear how firms can comply with the general principle to act in the client's best interest when they are explicitly exempted from applying rules that are best understood as a specification thereof.[81] Investment firms performing execution-only sales services, and thus enabled not to collect information on customers' features, cannot of course pursue their clients' best interests in the same way as when such information is available to them.[82]

Example of MiFID's Impact on Asset Managers' Civil Liability' 7 *Capital Markets Law Journal*, 386, 402 (2012).

[81] I. MacNeil, 'Rethinking Conduct Regulation' 30 *Butterworths Journal of International Banking and Financial Law*, 413, 415-416 (2016) (MiFID I rules often result in 'a regulatory scheme that implements a diluted form of fiduciary duties').

[82] An interesting combination of principle-based and rule-based regulation is offered by Australia, where a best interest standard is coupled with more detailed conduct of business rules that have the function of a safe harbour: while sticking to the safe harbour is sufficient for compliance purposes, firms are free to find other ways to ensure compliance with the general standards (A.F. Tuch, 'Conduct of Business Regulation', in N. Moloney et al eds, *Handbook of Financial Regulation* (Oxford: Oxford University Press, 2015), 557-558).