

Mis-selling of financial instruments

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A. Setting the Scene

Mis-selling of financial instruments occurs when:

- financial services providers (such as investment firms and credit institutions providing investment services)
- provide **inaccurate, misleading, or inappropriate advice or information** to consumers/investors in relation to such products,
- whether through **actions or omissions**, or
- if such products were to be included in their investment portfolios in the course of **portfolio management** under “mis-selling” conditions.

A. Setting the Scene

Accordingly, mis-selling may take place through:

- Commercial practices (e.g. advertisement, promotion)
- Investment services: i.e. investment advice and portfolio management

A common outcome of mis-selling is that the investor/consumer either makes a financial decision they would not have made otherwise, or they end up with a financial product that is unsuitable for their profile/needs.

A. Setting the Scene

- Mis-selling of financial instruments started emerging in developed financial markets, like those in the US and the UK in the early 1990s (in particular, mis-selling of over-the-counter derivatives became a prominent public issue during that decade).
- Over time, as 'financialization' advanced and income levels rose, financial mis-selling became a widespread issue across several jurisdictions.
- The global financial crisis (2007-2009) underscored this trend, highlighting the prevalence of mis-selling practices. Before the outbreak of the crisis, during the crisis and its aftermath, unforeseen and substantial losses for investors using financial instruments took place.

A. Setting the Scene

The mis-selling of financial instruments creates significant problems

- not only in terms of **investor protection**, as investors purchase products that are not suitable for them and often suffer substantial losses without having previously understood the risks associated with these products,
- but also in relation to the integrity of capital markets,

The **consequences** of mis-selling include severe disruptions to the livelihoods of ordinary households, erosion of trust, and increased volatility in capital markets. As a result, the mis-selling of financial instruments has emerged as a critical regulatory focus due to its potential to escalate into a broader socio-economic problem.

B. Delineation of Key Concepts

- Under what conditions can a retail client (investor) also be considered a consumer? This analysis aims to ascertain the circumstances under which investors may benefit from consumer protection law.
- An investor does not consume but rather invests in something; however...
- Categorization of clients under MiFID II: retail clients, professional clients, eligible counterparties
- Consumer definition under EU consumer protection law
- A retail client (investor) may also be a consumer if he/she is a natural person acting outside his/her business, trade or profession

B. Delineation of Key Concepts

- What is the scope covered by the term financial instruments?
- In fact, it would be more accurate and comprehensive to refer to **financial products** rather than just **financial instruments** in this context, taking into account that the term ‘financial products’ encompasses a broader range of products, including financial instruments, insurance products, and loans.
- How do “sustainable investment products” fit into the context of sustainability regulations, including references to sectoral laws, such as environmental legislation? The divergence in definitions and approaches to sustainability underscores the complexity of this area.

C. EU regulatory framework

Key factors underlying/causing 'mis-selling':

➤ **Contractual parties:**

- information asymmetry;
- limited rationality of investors / consumers;
- lack of financial literacy;

➤ **Mis-information** (such as inaccurate, misleading information, greenwashing)

➤ **Governance**

- inappropriate incentives (high sales targets and commission structures) leading to conflicts of interest;
- weak governance structures;

➤ **Inadequate oversight.**

C. EU regulatory framework

- Under EU law, in instances of mis-selling financial instruments to investors who are also consumers of financial services, several legal acts apply, and regulatory tools have been **progressively** introduced to address the issue.
- The key mechanisms to prevent mis-selling of financial instruments include:
 - information disclosure (overwhelming complexity and inconsistency resulting from the simultaneous application of various legal acts),
 - suitability assessment,
 - product governance, and
 - product intervention.

The collective implementation of these measures is intended to address mis-selling from various angles; however, the issue remains unresolved...

C. EU regulatory framework

- In relation to **consumer protection law**, primarily, assessment would include:
 - the Unfair Commercial Practices Directive,
 - the Consumer Rights Directive, and
 - the Unfair Terms Directive, which have a horizontal scope of application, covering the entire range of service and product providers, including financial services providers.
- The Consumer Credit and the Mortgage Credit Directive should also be included in the scope of analysis.

C. EU regulatory framework

Subsequently, scrutiny would extend to compliance with the relevant provisions of the **capital markets law** such as :

- the Markets in Financial Instruments Directive (MiFID II), encompassing information disclosure, product governance, and suitability or appropriateness requirements,
- the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation,
- the Undertakings for Collective Investment in Transferable Securities (UCITS V) and the Alternative Investment Fund Managers Directives (AIFMD), depending on the type of investment involved.

C. EU regulatory framework

- Finally, this would involve assessing whether the investment services provider complied with **sustainability legislation**, such as the Taxonomy Regulation (TR) and the Sustainable Finance Disclosure Regulation (SFDR).

However, how do investor protection, consumer rights, and corporate sustainability law interact intricately within this context?

D. Supervision and enforcement

- A 'mis-selling' case can be simultaneously brought before both the competent supervisory authorities and the courts. As both private law and conduct of business rules govern the same behaviors, there is a risk of legal uncertainty and inefficiency if the relationship between these two enforcement mechanisms is not well-structured.
- The impact on retail clients could have been mitigated through robust public enforcement of the suitability test and product governance rules. However, are competent authorities adequately equipped to handle such violations of MiFID II requirements?
- Moreover, in cases of mis-selling, multiple supervisory authorities may be involved, such as the consumer protection authority, the capital markets commission, or the relevant insurance regulator. This fragmented approach is unlikely to be effective.

E. Assessment

- It is widely referred that the EU's regulatory framework for marketing and distributing financial products is fragmented and lacks unified concepts and terminology.
- For instance, MiFID II could have included insurance-based investment products, which are often considered substitutes for certain financial instruments. The same holds true for UCITS V and PRIIPs, despite some progress being achieved.
- Therefore, the EU's sectoral approach to regulating investment products with similar economic features should be reassessed in relation to its efficiency, as varying regulatory frameworks for such products can lead to market segmentation and regulatory arbitrage.

E. Assessment

- In this rather problematic environment, legislative acts concerning specific aspects of sustainability are also added, which likewise apply when it comes to sustainable investment products.
- Furthermore, regulation of marketing communications is governed by the above acts, and their relevant provisions operate alongside consumer protection regulations.
- However, the interaction between these acts concerning the requirements for marketing, selling, and distributing financial products, particularly their alignment, is not clearly defined, creating challenges not only for obliged entities but also for investors, judges, and supervisory authorities.

E. Assessment

Necessary steps:

- Assessment of the effectiveness of existing laws based on specific criteria.
- Coordination of relevant legislation in cases of mis-selling sustainable investment products, including potential overlaps and conflicting provisions.
- Enhancement of supervision
- *The Commission Guidance on Directive 2005/29/EC regarding unfair business-to-consumer commercial practices in the internal market provides insights into how the UCPD interacts with other EU legislative acts, including consumer protection law.*