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Foundations of EU Securities Regulation

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Abstract

This is the introductory chapter of the book 'EU Securities Regulation: Aims, Tools and Idiosyncrasies', forthcoming with Oxford University Press. This chapter sets the foundations of the book as a functional, economics- and finance-grounded guide to EU securities market law. It designs a general method to interpret the relevant rules in light of their effect on economic choices, enabling the reader to check the alignment with the legislator's stated goals (aims), to identify the regulatory technique(s) to pursue each goal (tools), and to incorporate the specificities of EU law in designing securities regulation (idiosyncrasies). We therefore structure the analysis of the following content chapters as follows: I) market failures; II) stated goals; III) tools; IV) idiosyncrasies. In this foundations chapter, we identify four essential features of well-functioning securities markets: a) liquidity; b) price accuracy; c) effective project screening; and d) effective management monitoring. Whenever any one of these features is absent or insufficient in unaided markets, there is a prima facie case for securities markets law to intervene and restore those features, unless the cost of doing so exceeds the benefit. On this basis, we have identified nine areas of EU securities markets law supporting one or more of the four features and will write a chapter on each of them: 1) market abuse; 2) mandatory disclosure; 3) information intermediaries; 4) UCITS and AIFMD; 5) investment services; 6) trading venues; 7) short selling; 8) fintech; 9) sustainable finance. In addition, two cross-cutting chapters will focus on cross-border and international aspects and on supervision and enforcement. The book's ambition is to provide its readers with the tools to understand the economic and financial rationales of EU legal rules and the additional policy considerations that may lie behind them, so that they can independently make sense of, and interpret, EU securities markets laws and regulations that the book does not cover, whether because they are not among the topics it focuses on or, importantly, because they are enacted after the book is published.

Keywords: European Union, financial markets law, law and economics, securities regulation

JEL Classification: G14, G18, G28, K22

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In this foundations chapter, we identify four essential features of well-functioning securities markets: a) liquidity; b) price accuracy; c) effective project screening; and d) effective management monitoring. Whenever any one of these features is absent or insufficient in unaided markets, there is a *prima facie* case for securities markets law to intervene and restore those features, unless the cost of doing so exceeds the benefit. On this basis, we have identified nine areas of EU securities markets law supporting one or more of the four features and will write a chapter on each of them: 1) market abuse; 2) mandatory disclosure; 3) information intermediaries; 4) UCITS and AIFMD; 5) investment services; 6) trading venues; 7) short selling; 8) fintech; 9) sustainable finance. In addition, two cross-cutting chapters will focus on cross-border and international aspects and on supervision and enforcement.

The book's ambition is to provide its readers with the tools to understand the economic and financial rationales of EU legal rules and the additional policy considerations that may lie behind them, so that they can independently make sense of, and interpret, EU securities markets laws and regulations that the book does not cover, whether because they are not among the topics it focuses on or, importantly, because they are enacted after the book is published.

A. Introduction

Shares, bonds, derivatives. Exchanges, trading venues, over-the-counter markets. Underwriting, asset management, brokerage, market making. Listed companies, investment banks, mutual funds, rating agencies, investment advisers, traders, consumers of financial services...[1] EU securities regulation chiefly focuses on such instruments, markets, services, and players. This book aims to provide its readers with the tools to both interpret and critically assess this branch of EU law. In Part I, it describes the law's sources, the relevant institutions making and enforcing it, the goals and rationales of securities regulation, and the legal strategies to attain those goals. In Part II it analyses key aspects of EU securities regulation. This Chapter provides the law-and-economics foundations for later chapters' analyses of individual key areas of securities regulation.

B. Why an understanding of the economics of securities markets helps lawyers

Throughout this book, an outcomes-oriented approach is taken: attention is given to the effects that rules (or, decreasingly, the absence thereof) can be expected to have on the relevant economic players' behaviour and, ultimately, on social welfare. One may question the wisdom (and educational value) of taking an economic perspective. Why should economic insights have any bearing on the exact meaning of a given law provision? Is economics really helpful to evaluate the desirability of a given legal provision?

This sceptical view has at least two underpinnings. Firstly, one may question the epistemic value of economics altogether: can it really predict how people will behave, after it spectacularly failed to anticipate an event as momentous as the **great financial crisis**

[1] Throughout this book, the meaning of financial or economic terms such as these will seldom be provided. Any reader who may be unfamiliar with any of them is well advised to search for their entries in Wikipedia or Investopedia or ask an AI chatbot about them. From now on, to make sure the reader's attention is caught by any essential technical non-legal term, they will be in bold character.

("GFC")?[2] Secondly, and relatedly, are its fundamental assumptions, such as agents' rationality, realistic?

It is not for these authors to defend the dismal science from its detractors.[3] More modestly, the very basic view is taken here that, at its core, the law's purpose is to mould human behaviour, ie to prevent some harmful actions from being taken and/or to induce people to take some beneficial ones. Hence, how people react to a given rule, that is, how their behaviour changes in response to that rule is of the essence in judging a rule's effectiveness and, more generally, its impact. Economics' insights facilitate the understanding of whether and how people's conduct will change following the introduction of a new rule. It is a safe bet, to start with, that, faced with a new prohibition, sophisticated players will not *necessarily* take all steps to scrupulously avoid the prohibited behaviour.

First of all, sophisticated players may choose to engage in the prohibited activity, so long as their expected benefits from engaging in it are higher than their expected costs. The latter are both the monetary sanctions for violations, discounted by the probability that they are applied, and the monetary and non-monetary effects of negative market or social reactions to their illegal behaviour, similarly discounted. In other words, if a professional trader's calculation is that the probability of being sanctioned for the violation is 10%, the fine they will be subject to is 1 million euro, and the damage to their reputation if the breach becomes common knowledge (with a 20% chance of that happening) will be 2 million euro, then it will be rational for that trader to violate the rule if they expect to gain more than 500,000 euro from the breach. They may still not engage in the prohibited behaviour, but both at the time of shaping the prohibition and when it comes to supervising traders' behaviour it helps to keep in mind what the relevant parties' expected pay-offs will be.

Secondly, those sophisticated players may engage in actions that, while not against the law, allow them to enjoy the same benefits as the prohibited action would grant them, a phenomenon known as *regulatory arbitrage*. For example, if the law prohibits borrowing to buy shares (**margin trading**), for instance because lawmakers want to prevent a bubble from inflating even more, but does not prevent traders from buying a **call option** on the same shares, they can use the latter tool to bet on shares' upward movement, thereby contributing to further

[2] See eg F Sylos Labini, *Science and the Economic Crisis* (Springer 2016).
[3] See eg J Tirole, *Economics for the Common Good* (Princeton 2017).

inflating the bubble, and hence frustrating the rule's goal.[4] Yet, they will not have violated the prohibition.[5]

An additional phenomenon to be taken into account when evaluating a new rule's impact is that, once a given conduct is imposed, for instance, on the provider of an investment service, such as a duty to alert clients when a trade is inconsistent with their risk profile, the supply of that service may decrease. Any new rule requires investments in **compliance**; because the related costs are, at least in part, fixed, they disproportionately burden smaller firms and, at the margin, may even discourage new entrants. One effect of such a rule may thus be to reduce competition in the market, which may harm consumers more than the required conduct benefits them.

Finally, a given rule may be efficient today, but inefficient tomorrow. That is, the rule makes some market participants better off and no one else worse off, but that may only be true *as things currently stand*, that is, taking as given the present circumstances, such as the available technology, the current market structure, and so on. Yet, the rule may chill innovation, blocking value creation that is hard to predict but potentially huge. Alternatively, markets may evolve faster than laws adapt, rendering a once efficient rule obsolete.

Economics offers well-tested tools for predicting how rules affect the behaviour of sophisticated parties—that is, parties for whom the fundamental assumption of economics, namely rationality, is realistic enough. These predictions rest on modest premises: we need not assume perfect competition in all markets to expect competing organisations to take the course of action that maximises their profits.

But what about individuals, especially when acting outside their professional sphere, namely consumers of financial services? Can we really expect them to behave rationally as well? And if not, what predictions can we make about the rules' effects on their behaviour, if any? No one can seriously argue against the idea that individuals *do not* (always) behave rationally. Ronald Coase himself, in his Economics Nobel Prize lecture, quipped that '[t]here is no reason to suppose that most human beings are engaged in maximizing anything unless it

[4] It is likely that my counterparty will buy the shares itself **to hedge** against the risk it has undertaken by selling the call option, putting upward pressure on the market price. Similarly, if I buy the call option on a public **trading venue**, information about the trade will be publicly available, sending the signal that a trader out there is bullish about the market for the relevant shares, which may reinforce, however marginally, others' similar beliefs.

[5] As silly an example as it may seem, it happens to be the case that in a sophisticated jurisdiction such as the US the trade that one can engage in to profit from downward share movements, ie **short-selling**, is subject to legal constraints, while the purchase of a **put option** is not. See also Ch. 9.

be unhappiness, and even this with incomplete success'.[6] Does irrationality then imply unpredictability of human behaviour? Not if there is something regular, or systematic in the irrational behaviour that humans display.

Advances in psychology have shown that such regularities exist in the form of cognitive biases: deviations from rational behaviour that can be regularly observed in humans and traced back to how our brains work in understanding reality and making decisions.[7] The existence of such biases when we act on the market, especially as consumers, means not only that we may fail to act consistently with available information, but also that cunning operators may exploit our biases to enrich themselves to our detriment.[8] The use of **behavioural finance** to shape effective policies protecting consumers of financial services is now ubiquitous and EU policymaking is no exception in this regard.[9]

The ability to make predictions about how market players, be they professionals or consumers, will change, if at all, their behaviour following implementation of a new rule is intuitively important to design good regulation. A lawyer combining expertise on securities regulation with an understanding of its economic implications is best positioned to assist lawmakers and regulators in making the right regulatory choices.

Yet policy analysis is hardly alien to a lawyer's core task of interpreting the law. Whenever it is unclear whether (EU securities markets) law requires a particular conduct—so that a question of interpretation arises as to a rule's content—the interpreter is greatly helped by a good sense of both the underlying financial phenomena and the economic implications of the competing readings. In fact, because we have to assume that laws are rational and treat equals alike, a deep understanding of the economics of a given relationship helps us understand whether that relationship is similar to another and therefore to be treated in the same way or not. So long as rules of interpretation allow us to make this kind of consideration, for instance because the wording of the statute is ambiguous, and no other overarching principle precludes it, the economically justified interpretation has to be preferred.

Similarly, avoidance of regulatory arbitrage has become one of the recurrent goals of EU financial regulation.[10] Identifying functionally (economically) equivalent activities or conducts may thus lead, in the presence of textual ambiguity at least, to extending the scope of

[6] Ronald H Coase, *The Firm, The Market and the Law* (University of Chicago Press 1988) 4.
[7] The must-read introduction to this field is Daniel Kahneman, *Thinking, Fast and Slow* (Allen Lane 2011).
[8] John Armour et al., *Principles of Financial Regulation* (OUP 2016) (hereinafter PFR) Ch. 11.
[9] PFR (n 8) Ch. 11.
[10] See Ch. 12.

some rules to activities or conducts that formal interpretation would have left outside their scope.

Finally, one of the constitutional constraints to EU legislation is the proportionality principle: EU legislation must be suitable to attain its objectives and not go beyond what is necessary to achieve them.[11] Economic analysis can show how the parties concerned would alter their behaviour so as to make a rule, on a given interpretation, incapable of achieving its objective; the burdens that interpretation imposes can then hardly be said to be necessary, which weighs in favour of an alternative interpretation.

To conclude, economics helps lawyers both shape and interpret (EU securities markets) laws. For this reason, this book complements more traditional legal analysis with the tools from microeconomics and behavioural economics, in line with what is now a relatively long tradition in the field.[12]

C. The boundaries of securities markets

Securities law governs the conduct of participants in the markets where a particular subset of financial relationships is formed. What sets that subset apart is the channel: some financial relationships are formed on markets, others through intermediaries such as banks and insurance companies. This book is about the former, which, following the international jargon, we call "securities markets". Although the distinction between markets and intermediaries is blurred, we adopt it here for convenience, because it mirrors not only the traditional way of partitioning the financial system for regulatory purposes in many jurisdictions, but also how the European supervisory architecture is still shaped (securities markets, banks, insurance).[13]

Before making sense of this partition, let us first identify the broader phenomenon (the financial system). What functions does it perform within the economy? In other words, what kind of needs does it serve?[14] To put it in simple terms, think of what an individual (Ryan) may do with money (funds) they[15] have or would like to have. First of all, they may want to spend

[11] See Ch. 2.
[12] Nikolas Georgakopoulos, *The Logic of Securities Law* (Cambridge University Press 2017).
[13] See Ch. 2.
[14] This section draws from PFR (n 8) Ch. 2.
[15] In this book we use the gender neutral "they" to refer to individuals of unspecified gender.

it on some goods and services. The financial system supports Ryan by facilitating the transfer of that money to those who provide them with those goods or services (the payment function).

Secondly, Ryan may want to store their money safely to use it at a later time, or earlier if needed (implying a preference for **liquidity**): the financial system supports them by providing institutions that can perform that function, namely in the form of organisations (traditionally, **banks**), (**deposit**) contracts and other (liquidity management) arrangements.

Thirdly, Ryan may have money in excess of what they plan to spend today or in the near future and would rather invest it in the hope of having a higher sum available – ie a **return on** their **investment** – when they might need it (whether once they retire or whenever they incur extra-ordinary expenses, such as for their children's education or their own health). Here, the financial system supports Ryan by: (1) helping them identify the right investments (advice); (2) executing the purchase of such investments (via **brokerage** services and/or the activity of **market-making**); (3) taking custody of the relevant **financial instruments**; (4) monitoring the investment's performance and, possibly, (5) recommending the sale of those financial instruments in order to find a better allocation for their funds (advice, again).

Fourthly, the financial system allows those, individuals and firms, who have less money than they can put to good use, to fill their funding gap and therefore finance their expenses and activities: some organisations (traditionally, **commercial banks**) will directly fund them, while others (such as **investment banks**) will match fund-seekers with investors. These organisations screen for good projects and monitor their execution.

Finally, instead of just taking events as they come, individuals and firms may pro-actively discern looming risks and be willing to minimise the financial consequences of those risks materialising. They may do so by purchasing a promise that the financial impact of such events will be neutralised by the counterparty (typically an **insurance company**). That is just another form of investment, except that in its basic configuration, no return is expected. The insured's payoff is contingent on the negative event materialising—eg, the death of a supporting family member—and makes the buyer of insurance indifferent to the event's consequences.[16]

[16] PFR (n 8) 495-6.

The financial system thus comprises the institutions and markets that are needed to transfer, store, invest or raise funds, and to manage the financial consequences of risk.[17] In other words, it comprises the agents, the organisations (firms), the services, the contracts, the know-how, and the networks that ensure that such functions are performed. In doing so, the financial system allocates capital within the economy and monitors its use on the part of funds users. It is thus a core component of any country's economy. Without a well-functioning financial system, economic activity would run far less smoothly. More importantly, long-term growth depends on capital being allocated to the right uses and on the effective monitoring of those who receive the funds.

Securities markets, via the trading of financial instruments, can perform almost all the functions of the financial system as an alternative to banks and insurance companies.[18] To see this, consider that banks typically perform the financial system's functions by taking deposits – which are liquid, may offer a return, and can be used for payments – and supplying credit, which funds projects. Insurance companies typically undertake to cover the insureds' losses by pooling risks in exchange for a fee called premium.

We are instead within the domain of securities markets when the typical functions performed by the financial system take the form of: **(a)** a direct relationship between those who have funds in excess and those who seek funds; **(b)** spot transactions between market participants, where the financial instruments representing those direct relationships are exchanged; **(c)** assistance in the establishment of such relationships and the execution of such transactions; and **(d)** the pooling of small investors' funds into a professionally managed portfolio of financial instruments. One example of:

(a) is when a retail investor (Alex) buys shares in the **IPO** (**initial public offering**) of what Alex hopes will be the next Nvidia;

(b) is when, after a few months of spectacular rises in those shares' market price, Alex sells them on the stock exchange to an unknown buyer;

(c) is an intermediary that assists the next Nvidia in finding buyers like Alex at the IPO stage (**underwriters**) or, further down the road, buyers for Alex's shares (**brokers** or **market-makers**);

[17] Of course, *financial* risk management is not the only option. Risk is pro-actively managed also via organisational and technological devices that preventively lower the likelihood of a negative outcome.
[18] Except payment services: see PFR (n 8) 34.

(d) is when Alex doesn't have enough money to invest in the next Nvidia without bearing uncompensated **idiosyncratic risk** and rather purchases a share of a collective investment scheme (a **mutual fund** or **ETF**) that includes the next Nvidia's shares in its diversified portfolio.

Sometimes the *form* these services and activities take is misleading. Some activities that are formally within the realm of securities markets are functionally closer to banking or insurance. Vice versa, some activities that take the form of a banking transaction (or an insurance contract) are functionally closer to securities markets. Borrowing language from statistical inference, we call the first case **false positives** – activities that formally *do* belong to securities markets but functionally don't – and the second case **false negatives** – activities that formally *do not* belong to securities markets but functionally do.

As an example of false positives, take, first, a bank issuing **commercial paper** in order to finance its core lending activities. That transaction is held to be a securities market one, although what the bank is doing is functionally equivalent (from the perspective of how banks finance their lending and therefore perform their core economic functions) to taking money in the form of fixed-term deposits. Or consider **money market mutual funds (**MMMFs**)**, that is, companies or trusts set up and managed by **asset management** firms, that allow individuals to store funds for use in the proximate future, by pooling and investing them in short-term instruments: MMMFs are usually considered as securities markets products, despite their function being so similar to banks' deposits. Finally, think of investment banks selling protection against various financial risks by underwriting **derivatives** that make them liable to pay counterparties a sum of money if a given event, such as a borrower's default, occurs. Such **over-the-counter** derivatives markets, which perform the same function as insurance contracts when counterparties' goal is to manage their risks, are commonly viewed as part of securities markets.

In all these examples, an intermediary formally uses the securities market to perform some financial system's activities but functionally acts like a bank or insurance company. More precisely, banks perform **liquidity, maturity, and risk transformation**.[19] The typical depositor's claim on a bank – such as a deposit – is liquid (it can be sold for cash); immediate (it can be redeemed on demand); and certain (it is worth its face value). A bank can promise

[19] This transformation is profitable because the yield on illiquid, long-term, risky debt is higher than the yield on liquid, short-term, and safe debt. Banks are 'merchants of debt'. Hyman Minsky, *Stabilizing an Unstable Economy* (Yale University Press 1986).

depositors these features regardless of the liquidity, maturity, and riskiness of the bank's use of the borrowed funds, such as, for instance, financing the next Nvidia's factory (ie, an illiquid asset) with a loan maturing in 10 years (ie, such that the related funds cannot be claimed on-demand) with a 20% probability of default (ie, risky). We hasten to add that liquidity, maturity and risk transformation is inherently fragile: **bank runs** – ie, correlated withdrawals – occur when depositors collectively lose confidence in the banks' ability to make good on their liquidity-immediacy-safety promises.[20]

While banking regulation and deposit insurance try to cope with this problem, the above examples of false positives show that it is possible to mimic the operation of a bank using securities markets. Short-term commercial paper may be issued to fund long-term projects, purchased by MMMFs to back their promise to redeem their shares on demand; credit derivatives insure against the risk of projects' default. As revealed by the GFC, runs may occur on all these financial instruments—commercial paper, MMMF shares, and credit derivatives—even though they are not issued by banks.[21] Liquidity, maturity, and risk transformation carried out outside the regular banking system is known as **shadow banking**, or, in the regulators' preferred phrase, non-bank financial intermediation; the securities-market techniques just described are one of its forms.[22]

Credit derivatives and shadow banking

Credit derivatives formally belong to securities markets but appear functionally equivalent to providing **insurance** against the borrower's default. However, there is one important difference: buyers of insurance can only be compensated to the extent that they incur an actual loss, whereas buyers of credit derivatives get their payoff even if they have no exposure to the borrower's default. Functionally, insurance contracts do not support maturity, liquidity, and risk transformation because compensation requires an 'insurable interest'.[23] Therefore, pooling uncorrelated risks and provisioning the premiums to compensate insureds' losses are sufficient to ensure stability and confidence in insurance companies. Conversely, because they may compensate buyers in the absence of losses,

[20] Douglas W Diamond and Philip H Dybvig, 'Bank Runs, Deposit Insurance, and Liquidity', 91 *Journal of Political Economy* (1983).
[21] See Marcin Kacperczyk and Philipp Schnabl, 'When Safe Proved Risky: Commercial Paper during the Financial Crisis of 2007-2009', 24 *J Econ Persp* (2010); Gary Gorton and Andrew Metrick, 'Securitized Banking and The Run on Repo', 104 *J Fin Econ* (2012).
[22] Hossein Nabilou and Alessio M Pacces, 'The Law and Economics of Shadow Banking', in Iris H-Y Chiu and Iain G. MacNeil (eds), *Research Handbook on Shadow Banking* (Edward Elgar 2018), 7-46.
[23] PFR (n 8) 496-7.

credit derivatives enable liquidity, maturity, and risk transformation: credit derivatives can be sold for cash, allow buyers to withdraw before maturity by calling collateral, and are considered safe even though they cover correlated risks, such as subprime mortgage defaults.[24] When confidence deteriorates, issuers of credit derivatives, such as the investment banking arm of American International Group (AIG) back in 2008, are subject to runs. By issuing credit derivatives to agents without risk exposure, AIG was acting as a shadow bank.[25]

The difference between form and function can also lead to false negatives: some activities are, in form, outside the realm of securities markets but, because they perform the same functions, should be considered within their domain. One example, within the EU, is insurance companies selling investment management products with exactly the same features as collective investment schemes (**UCITS**), namely a return on investment which, apart from diversification, involves no risk-management element, such as a payoff contingent on the buyer's personal circumstances.

While collective investment schemes have traditionally fallen within the domain of securities regulation that imposes elaborate disclosures to protect investors, the identical products issued by insurance companies have until recently been exclusively subject to insurance legislation. Because such legislation has traditionally been far less sensitive to the idea that investor protection concerns justify disclosure mandates, these investment products used to be much less transparent than collective investment schemes.[26]

Another past example of false negatives is banks raising funds by placing their own bonds with their clients. Formally, this is credit intermediation because it neither establishes nor facilitates a direct relationship between fund givers and ultimate fund seekers: banks will conclude different contracts with the latter. Thus, until a recent reform, EU securities regulation considered this as banking. However, when issuing bonds, banks are, in substance, acting as fund seekers establishing, through their bonds, a direct relationship with fund givers. Differently from deposits or MMMFs, there is no liquidity, maturity, or risk transformation

[24] PFR (n 8) 471-2.
[25] Toshiaki Hirai, Maria Cristina Marcuzzo, and Perry Mehrling, 'Financial Globalization and the Future of the Fed', in Toshiaki Hirai, Maria Cristina Marcuzzo, and Perry Mehrling (eds), *Keynesian Reflections: Effective Demand, Money, Finance, and Policies in the Crisis* (OUP 2013), 268-285.
[26] Nowadays, the PRIIPs Regulation (arts 4 and 5) mandates disclosure in the form of a Key Information Document (KID) for the distribution to retail investors of collective investment schemes and insurance-based products whose values depend on market fluctuations.

here. Bond liquidity depends on the market in which they are traded (if they are traded at all), they cannot be redeemed before maturity, and investors face the risk of issuer failure because bonds are not covered by **deposit insurance schemes**. As with selling other financial instruments, the problem with bank bonds is not (only) financial stability, but (also) investor protection: investors may misjudge the investment risk of bank bonds due to behavioural biases and banks may take advantage of these biases.[27] Functionally, we are thus in the domain of securities markets despite the presence of a bank. European rules have acknowledged this in the MiFID II directive, which extends conduct of business rules for investment services to the placement of bank bonds by the bank itself.[28]

Does all this matter? If a given phenomenon falls under the purview of securities regulation but is functionally equivalent to another phenomenon that is addressed with the tools typical of banking regulation, then there may be scope for regulatory arbitrage: any time the securities regulation rules applying to the phenomenon are less burdensome than banking regulation rules, whether for their contents or for how they are enforced by the relevant regulators, market players have an incentive to structure their transactions as "securities markets" ones. A good example is shadow banking, which allows financial intermediaries to avoid banking regulation using securities markets to perform maturity, liquidity, and risk transformation. But it may work also in the opposite direction: financial intermediaries may choose to legally structure fund raising activities as banking or insurance transactions, as opposed to securities market ones, to avoid more burdensome investor protection rules.

While the regulatory boundaries between securities markets and banking or insurance sometimes respond to non-functional logics, the scope of this book is clear-cut. We deal with a number of legislative instruments that regulate phenomena that are functionally within the domain of what are known as securities markets: we focus in fact on the trading of *negotiable securities* and on the institutions, such as regulated markets, investment services providers, and information intermediaries, that make such trading possible.

D. The essential qualities of securities markets

To appreciate the importance of securities regulation, it is useful to illustrate the challenges that the users of securities markets face. Let E-Motion NV be an automotive start-

[27] PFR (n 8) 246-247.
[28] MiFID II, art 4(1)(5), qualifies bond issuance by banks as an investment service.

up that plans to go public on Euronext and raise ten billion euro in stock. Let us also imagine that Alex inherited 100,000 euro and is considering investing this amount with a view to providing for their retirement further down the road. How can E-Motion, which might become a leading electric car company but may also spectacularly fail, persuade Alex to invest in it? After all, Alex is unlikely to know much about the automotive industry and its prospects and may be even less knowledgeable about securities markets and how they work. It is also unlikely for Alex to know E-Motion's founders and managers personally and thus have a chance to understand whether they are committed and trustworthy. In addition, Alex may not like the idea of totally losing control over their money if they transfer it to E-Motion in exchange for its shares.

As many have observed,[29] there is something magical about the fact that Alex may be willing to purchase E-Motion's shares despite all that. It is similarly magical that, after the shares are listed, it will be easy to find a buyer for its shares every single day. Issuers can succeed in getting funding from the likes of Alex only if the right combination of markets and regulation creates an ecosystem that addresses two core investor concerns: investors must be reassured, first, that they will get their money back (with a capital gain or net of a loss, reflecting how their investment has done in the meantime) as soon as they, perhaps unexpectedly, need it (for example because Alex must pay for costly surgery). Second, they want reassurance that their money will not be lost because of the infidelity or incompetence of those entrusted with it. Four essential qualities are necessary to address these concerns: liquidity, price accuracy, project screening, and management monitoring.

The Alexes of this world require ***liquidity*** of E-Motion's securities because they anticipate that they may need their money back while E-Motion is still busy building and then selling its cars (or whatever will replace cars in the future). Unlike a bank deposit – which is liquid by definition – E-Motion shares have an indefinite maturity – as indefinite as the company's life. Alex cannot claim their money (and the return on it) from E-Motion. That makes sense because, meanwhile, E-Motion has invested the money in physical and intangible capital that could only be liquidated at a loss: in other words, E-Motion founders would not have tapped equity markets to begin with if they were at the mercy of the liquidity needs of their shareholders. If Alex unexpectedly must pay for a costly surgery after 3 years or suddenly

[29] See eg Bernard S Black, 'The Legal and Institutional Preconditions for Strong Securities Markets', 48 *UCLA Law Review* (2001), 782; Andrei Shleifer and Robert W Vishny, 'A Survey of Corporate Governance', 52 *Journal of Finance* (1997), 737.

decides to retire after 10 years, they can collect the current value of their investment (including the return on it) by selling their shares on the secondary market. Only on that condition will Alex consider purchasing stocks from E-Motion on the primary market as opposed to depositing money in a bank.

A financial instrument traded on a secondary market can be defined as *liquid* when it can be traded with no impact on its market price. Why should trades have an impact on price? If there are more Alexes willing to sell their shares than Ryans willing to purchase them, the price must go down to attract potential buyers (and the other way round).[30] If Alex and Ryan have reason to fear this scenario, they will be reluctant to invest in the first place.[31] To obviate this problem, **market makers** emerge who commit to buying a particular security for a "bid" price and selling it for a higher "ask" price. The difference between these prices is the cost of liquidity and is called the **bid-ask spread**. The higher the spread, the less liquid the market.

Alex and Ryan will also be concerned that, when they buy or sell securities on the secondary market, they pay or receive an *accurate price*. A stock price is accurate if it reflects the expected value of the payments by E-Motion over the company's life. The complication is that these payments are *fundamentally uncertain* because unpredictable circumstances – such as changes in nature, technology or regulation – may affect E-Motion's ability to pay dividends.[32] Normally, unforeseen contingencies can be ignored because they are unpredictable and uncertainty is resolved gradually by trading on new information. Therefore, the most accurate price is one reflecting all information about the security's future **cashflows** that is available *today*.[33] By clearing at this price, an *informationally efficient* market reassures Alex and Ryan that they can buy and sell securities for the best estimate of how the investment is doing—short of unforeseen contingencies. However, unforeseen contingencies potentially undermine price accuracy: E-Motion might end up paying higher or lower dividends than expected because events turn out respectively better or worse than expected. When uncertainty

[30] Alex may have to overpay for shares if for any reason they only have access to secondary markets and these are illiquid. If there are not enough Ryans willing to sell in such markets, the price must increase to attract sellers.
[31] More precisely, anticipating illiquid secondary markets, investors are only willing to buy shares at a discount, to reflect the risk of having to sell their shares at a lower price. That, in turn, will imply a higher cost of capital for companies such as E-Motion, with some of them deciding not to go public to begin with. Ultimately, some positive net present value projects may go unfunded.
[32] John Kay and Mervyn King, *Radical Uncertainty* (The Bridge Street Press 2020). Frank Knight, *Risk Uncertainty, and Profit* (Houghton Mifflin 1921), first distinguished risk from uncertainty. Whereas *risk* is predictable and commands a lower price to attract risk-averse investors, *uncertainty* cannot be modelled by a probability distribution. This implies that securities prices can never be entirely accurate.
[33] Merritt B Fox, 'Measuring Share Price Accuracy', 1 *Berkeley Bus L J* 113 (2004).

about these payments is high, bid-ask spreads widen and prices may depart from the accurate value.[34]

Because an informationally efficient market resolves uncertainty by swiftly incorporating new information as it becomes available, price accuracy requires rewarding *professionally informed traders*.[35] These are analysts working for **institutional investors** and any specialised trader who profits from trading based on the information they have uncovered. Their gains are the cost of price accuracy. Professionally informed traders provide price accuracy to Alex and Ryan, but may also undermine it, particularly if they chase speculative noise—ie, what other traders expect the future price to be—as opposed to the fundamental value of the expected payments from issuers. Such trading can leave the price informed but inaccurate: it may reflect expectations about the future price but not the expected issuer's payments. The result can be a bubble that persists until new contingencies change informed traders' behaviour.[36] Informationally efficient markets in which bubbles are frequent dissuade Alex and Ryan from participating in securities markets.[37]

The third essential quality of securities markets is the *screening of projects* on the primary market. When E-Motion first offers its securities in an **initial public offering (IPO)**, Alex and Ryan are unlikely to have the knowledge required to assess the issuer's prospects, how liquid the secondary market for E-Motion's shares will be, and whether the IPO is attractive in view of the expected secondary market price. E-Motion's managers know the project's quality better but may have a hard time distinguishing themselves from dozens of other startuppers of lower quality. Severe **asymmetric information** between issuers and investors can undermine the securities market: promising issuers may never enter the market, whereas subpar ones will try to sell cheap securities trumpeting their prospects if not providing

[34] In the economic literature, this is called the 'uncertainty spread'. David Easley and Maureen O'Hara, 'Liquidity and Valuation in an Uncertain World', *J Fin Econ* (2010). Securities affected by unforeseen contingencies, for example the GFC or a hurricane, become illiquid and can be traded only for prices remote from the accurate price. As investors become unable to form rational expectations about a security's value, they refrain from trading it despite having information on the expected payments and their risk. Empirical evidence confirms the presence of uncertainty spreads. Dominic Rehse et al, 'The Effects of Uncertainty on Market Liquidity: Evidence from Hurricane Sandy', *J Fin Econ* (2019).

[35] Ronald J Gilson and Reinier H Kraakman, 'The Mechanisms of Market Efficiency', 70 *Va L Rev* (1984).

[36] Fox (n 33) 119. See also J. Bradford De Long, Andrei Shleifer, Lawrence Summers, and Robert Waldmann, 'Noise Trader Risk in Financial Markets', 98 *J Pol Econ* (1990).

[37] Regulation could mitigate the adverse effect of uncertainty on price accuracy by insuring unsophisticated investors against extreme negative events, such as catastrophes or financial crises, and protecting them from aggressive marketing of financial instruments through suitability rules. See David Easley and Maureen O'Hara, 'Ambiguity and Nonparticipation: The Role of Regulation', *22 Rev Fin Stud* (2009).

false or misleading information until the market unravels as a typical 'market for lemons'.[38] Conversely, good project-screening leads to *allocatively efficient* securities markets: all projects with positive net present value and only these projects are funded, which generates returns for investors.[39]

This virtuous circle is supported by *reputation intermediaries*, particularly investment banks performing underwriting services. **Underwriters** are market professionals that assist an issuer in an IPO: they have to find buyers for the IPO shares at a price that satisfies both the IPO company and the buyers. In the process, they screen for promising issuers. In fact, differently from E-Motion's managers, underwriters are repeat players in IPOs: they serve a number of issuers across time and can only find buyers for their shares if they develop a reputation for bringing good-quality issuers to the market—or, at least, for not selling their shares at a price higher than the issuer's prospects would justify. In so doing, they lend their reputation to the issuer, thereby attracting buyers for its shares.

In addition to underwriters, reputation intermediaries include securities analysts, lawyers, auditors, **rating agencies**, and other *gatekeepers*.[40] These players' key role is to certify the information provided by the issuer's management, making it credible for investors like Alex and Ryan: like underwriters', gatekeepers' reputation is on the line if they provide inaccurate or plainly fraudulent certifications. Along with regulations, courts, and other institutions, gatekeepers filter out crooks and charlatans by refusing to certify false or misleading information. Gatekeepers typically have numerous clients: they have little to gain from falsely certifying information pertaining to one of them. They stand to lose their main asset—reputation—in case they do. With the right incentives, gatekeepers such as lawyers may even go as far as to deter fraud by actively monitoring managers. In sum, an ecosystem populated by credible reputation intermediaries screening and monitoring management encourages investment.

Management monitoring is the fourth and final essential feature of securities markets. Without it, investors would have no guarantee that managers will not misuse their money after gaining control over it, regardless of how promising the project was. Misuse of investor money

[38] George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism', 84 *Q J Econ* (1970).
[39] PFR (n 8) 26 (screening of projects by securities markets leads to a virtuous circle between savings and investments).
[40] See Ch. 5. Cf. also John Coffee, *Gatekeepers: The Professions and Corporate Governance* (OUP 2006) and Reinier H Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy', 2 *J L Econ & Org* (1986).

can take the form of either 'stealing' (diverting money to managers' own pockets through self-dealing or excessive compensation) or inefficient investments due to shirking or empire building. These are two facets of managerial **agency costs**, which monitoring can reduce.[41] Monitoring self-dealing and similar behaviour is a precondition for securities markets to function.[42]

Monitoring bad (but honest) management is more difficult: a bad outcome can depend on bad luck, bad choices, or both.[43] However, in liquid markets, professionally informed traders compete aggressively to impound new information into price, including to reflect managerial shirking and empire building.[44] As the stock price decreases, corporate governance mechanisms kick in to provide effective monitoring. First, incompetent managers may be replaced by better managers via a hostile takeover. Second, activist hedge funds may engage with management to change a company's (faulty) strategies. Third, managers themselves may reconsider their firm's strategy as managerial compensation is tied to falling stock prices.

Indirect investor protection of this kind is less effective in the presence of **insider trading**. Market professionals adjust to insider trading by increasing the bid-ask spread, but that reduces liquidity. Combined with the lower profits that come from trading against insiders, lower liquidity hampers the monitoring of managers by professionally informed traders. As insider trading undermines both liquidity and monitoring, it reduces securities markets' attractiveness for investors.[45]

E. Market failures, the goals of EU securities regulation, and its tools and idiosyncrasies

We have divided this book into eleven thematic chapters on key aspects of EU securities regulation. Chapters will be structured as follows: 1) market failures; 2) stated goals; 3) tools; 4) idiosyncrasies. In this section, we introduce each of these four headings in turn.

[41] Michael C. Jensen and William H. Meckling, 'Theory of The Firm: Managerial Behavior, Agency Costs and Ownership Structure', 3 *J Fin Econ* (1976).
[42] Black (n 29).
[43] Absent a conflict of interest, there are (or should be) hardly any legal grounds to blame managers for a business decision that turned out badly. Mark J Roe, 'Corporate Law's Limits', 31 *J Leg Stud* (2002).
[44] Zohar Goshen and Gideon Parchomovsky, 'The Essential Role of Securities Regulation', 55 *Duke L J* (2006).
[45] Holger Spamann, 'Indirect Investor Protection: The Investment Ecosystem and Its Legal Underpinnings', 14 *J Legal Analysis* (2022).

Market failures are frictions that prevent securities markets from performing their functions in a way that maximises social welfare. For instance, when market failures impair markets' project-screening function, financial resources are misallocated: some good (value-creating or positive-net-present-value) projects go unfunded, while some bad (negative-net-present-value) projects get funding.

A prominent cause of market failure in securities markets is **asymmetric information**: investors know less than issuers about the quality of projects and how the managers implement them. Because of asymmetric information, adverse selection may hinder project screening, resulting in a 'market for lemons'. The same asymmetric information makes it hard to monitor managers, contributing to managerial agency costs.[46] Although, as we have seen, market solutions, such as reputational intermediaries, emerge to cope with these problems, regulation may still be necessary to address such market failures.

Another important market failure is **externalities** (positive and negative). An activity (say: monitoring the conduct of a listed firm's management) generates positive externalities when the actor cannot appropriate all the benefits, because some of these benefits will accrue to others (anyone else investing in that listed firm). Therefore, the actor will invest less in that activity than is socially desirable. Take information disclosure by public firms: because it benefits also non-disclosing firms' investors (in the sense that, for instance, information disclosed by firm A is relevant also to gauge the future **cashflows** of its competitor B), disclosure may be underproduced, which in turn undermines price accuracy and may justify mandatory disclosure. **Public goods** similarly suffer from this free riding problem. Liquidity, for example, is underproduced, because it benefits actual and potential market participants. Market-making is a solution, but the bid-ask spread market makers demand could be very large in the absence of regulatory subsidies such as the prohibition of insider trading.

Externalities are negative when actors do not bear all the costs of their actions. In this case, the actions are overproduced, as in the case of systemic risk (firms do not bear all the consequences of risk-taking, as evidenced by the GFC) and market manipulation (one egregious case of market manipulation may destroy investors' trust in securities markets and therefore raise every firm's cost of capital but the perpetrators would not bear all the consequences of their actions). Regulation then curbs these actions—or at least so it should.

[46] See text to nn 41-42.

Finally, market failure may depend on the lack of **competition**. In the context of securities markets, competition among financial intermediaries reduces the cost of financial services, such as brokerage fees, market makers' bid-ask spread and asset management fees. By lowering the cost of financial services, competition makes markets more attractive for both issuers and investors, increasing their liquidity and ability to screen projects. Yet, economies of scale and scope (not to mention the fixed costs of regulatory compliance) can cause investment services markets to depart from perfect competition, thereby depriving some consumers of access to such services.

One final caveat before moving on: identifying a market failure is not yet a prescription for regulation. To infer the second from the first is to fall into what Demsetz called the nirvana fallacy—judging imperfect markets against an idealised regulator rather than against regulation as it can realistically be expected to work.[47] Real rules are obeyed imperfectly, violations are detected and sanctioned imperfectly, and the authorities that write and apply them operate with limited information and under the pull of the interests they supervise. And regulatory intervention has costs of its own: not only the resources spent on compliance and supervision, but also the transactions a rule deters, which are all the harder to see precisely because they never take place.

And yet market failures are key to interpret the goals of EU financial regulation. These goals are often stated explicitly in the preambles of EU securities markets legislation.[48] *Stated goals* may align with correcting market failures but sometimes differ. This book takes such stated goals as a given, but it also aspires to make sense of them. It does so by drawing on the insights of economics, within the boundaries set by EU rules of interpretation. This approach helps the interpreter apply the relevant rules also in light of their expected effects on the decisions the rules ultimately shape, such as an investor's choice between holding shares directly and delegating to an asset manager or an issuer's choice between a public listing and private funding.

As individual chapters show, three recurring stated goals of securities law are *investor protection*, *market efficiency*, and *competition*.

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[47] Harold Demsetz, 'Information and Efficiency: Another Viewpoint', 12 J L & Econ 1 (1969).

[48] Recital (1) of the Transparency Directive offers a particularly clear synthesis of EU securities regulation's aims:

> 'Efficient, transparent and integrated securities markets contribute to a genuine single market in the Community and foster growth and job creation by better allocation of capital and by reducing costs. The disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance and assets. This enhances both *investor protection* and *market efficiency*' (emphases added).

Historically, *investor protection* has been the main rationale for securities regulation, first in the US[49] and then in the EU,[50] whose harmonisation efforts have followed the footsteps of US securities regulation closely.[51] The investor protection goal is intuitive: investors are reluctant to buy securities if they can't trust issuers and financial services providers, which they might fear to abscond with their money instead of making good on their promise to return it. Our discussion so far has shown that securities markets have their own ways of overcoming this reluctance, for instance via the use of reputation intermediaries, such as **audit firms**, that provide assurance regarding financial disclosures. Yet, such market mechanisms may be imperfect and, in some cases, regulation can improve on market outcomes for investors, which it often does by enhancing the role of reputation intermediaries themselves.[52]

Framing policy issues in terms of market failures helps interpret investor protection rules. Mandatory disclosure, for example, is meant to protect investors by reducing asymmetric information. However, because most retail investors neither read nor can understand financial disclosures, their protection does not hinge upon their processing the mandated disclosures. Expecting this behaviour is an example of the nirvana fallacy.[53] Rather, mandatory disclosure protects investors indirectly, that is, by subsidising information acquisition by professionally informed traders, which enhances the liquidity and price accuracy retail investors can count on. Another example is reputational intermediaries. Rules supporting certification by gatekeepers enhance project screening and monitoring of management, which indirectly protect investors.

Even more important for investor protection is *market efficiency,* which is a second prominent goal of EU securities regulation.[54] Efficient securities markets provide both price accuracy and liquidity, which help attract investors and channel savings into productive investment.

Although it is allocative efficiency that ultimately matters for social welfare, in the context of securities regulation market efficiency is usually understood as informational efficiency. That is the ability of market prices to reflect all (publicly) available information almost instantaneously, thanks to traders' activity as soon as new price-sensitive information

[49] Stephen J Choi and Adam C Pritchard, *Securities Regulation: Cases & Analysis* (5th edn, Foundation Press 2019) 1.
[50] Rüdiger Veil, *European Capital Markets* (Hart Publishing 2017) 24ff.
[51] Daniel Kelemen, *Eurolegalism* (Harvard University Press 2011) 101, citing Eilís Ferran, *Building an EU Securities Market* (Cambridge University Press 2004) 35-36.
[52] See Ch. 5 and 11.
[53] See text to n 47.
[54] See eg Prospectus Regulation, recital (7), and MiFID II, recital (164).

materialises. Importantly, though, allocative efficiency and informational efficiency are strictly related. First, informationally efficient secondary markets support both price accuracy and liquidity, which together assure investors that they can exit an investment quickly and at a fair price. Investors who expect such a market are therefore willing to subscribe to an IPO, and to pay more for the securities on offer, which lowers the issuer's cost of funding new projects on the primary market. Second, managers of publicly held companies can learn from informationally efficient prices and reallocate existing capital to the best projects, for failure to do so results in lower prices, lower compensation, and potential dismissal.

Market failures may undermine the informational efficiency goal. First, because information about company A is also useful to gauge the value of its competitors B, C, and D, while company A is not rewarded for the benefits investors in B, C and D derive from its disclosures, company A will disclose less information than is socially optimal. Second, because liquidity has public good features, market makers will undersupply it unless regulation subsidises them. Mandatory disclosure addresses the first problem as it compels issuers to disclose more information than they would do voluntarily. The prohibition of insider trading, coupled with ongoing mandatory disclosure,[55] reduces the asymmetric information problem faced by market makers, which will in turn lower their bid-ask spreads, thereby increasing market liquidity.

The third key goal of EU securities regulation is *competition*.[56] More competition implies lower prices (eg, lower bid-ask spreads), higher quality (eg, faster order execution), enhanced liquidity, and ultimately better functioning of securities markets.[57]

Within the EU constitutional framework, the competition goal is intertwined with the goal of establishing the single market.[58] In pursuing the integration of capital markets and financial services, the EU has established pan-European validity for a number of licences to provide financial services obtained in one Member State (**mutual recognition**). This option is premised on the presumed equivalence of regulatory requirements across Member States, an equivalence that harmonised EU rules are meant to secure. By widening the relevant financial services market, such an EU 'passport' promotes competition—provided that the

[55] PFR (n 8) 186.
[56] PFR (n 8) 68.
[57] Georgakopoulos (n 12) 143ff.
[58] TFEU art 3(1)(b).

procompetitive effects of mutual recognition outweigh any anticompetitive effects of the harmonised EU rules.

Securities regulation uses specific *tools*, or types of regulatory intervention, to achieve its goals, such as licences (entry regulation), duties towards customers or prohibitions of a certain behaviour (conduct regulation), and duties to inform the public (mandatory disclosures). These tools may be more effective at pursuing some goals than others. In addition, when goals conflict with each other (such as competition versus financial stability), a tool promoting one goal may undermine another, and their effectiveness at correcting market failures varies. Finally, tools may be chosen whose costs exceed the benefit of correcting the relevant market failure, ie regulation may be inefficient.

Entry regulation works by screening access of financial firms and products before they can access the market. Entry of financial firms is subject to licensing mainly to facilitate enforcement of other tools: for instance, licensed firms can be requested to report on their conduct and denied access to regulated markets upon failure to do so. A major disadvantage of entry regulation is that it restricts competition imposing higher costs and less choice on investors. Yet fostering competition entails trade-offs too: for example, liberalising entry of trading venues to reduce the cost of securities markets may result in fragmentation and undermine liquidity.[59]

Conduct regulation has become the main tool for investor protection. In their relationship with retail investors, investment services providers are subject to conduct of business rules commanding fair dealing, proper handling of client assets, and management of conflicts of interest under penalty of administrative and sometimes civil liability.[60]

Conduct of business rules also aim at reducing the agency costs of investing in securities markets by prohibiting market manipulation and insider trading, under penalty of administrative and criminal liability.[61] These prohibitions aim at promoting market liquidity as they protect market makers from systematic exploitation by insiders and other crooks.

Despite its wide use, also conduct regulation entails costs. Conduct of business rules undermine competition as they act as a barrier to entry for smaller firms. The prohibition of insider trading enhances liquidity at the expense of price accuracy.[62]

[59] See Ch. 8.
[60] See Ch. 7.
[61] See Ch. 3.
[62] Henry Manne, *Insider Trading and the Stock Market* (Free Press 1966).

Mandatory disclosure mainly aims at market efficiency as it subsidises information acquisition by professional traders. It also serves the goal of investor protection but only indirectly, as a byproduct of price accuracy. Yet mandatory disclosure has its own drawbacks. Disclosure obligations are particularly burdensome for new issuers and especially for highly innovative firms, because mandatory disclosure may reveal proprietary information. Hence, such obligations may deter some issuers from going public, to the detriment of public markets as a whole. The larger the population of issuers, the better the market screens projects and monitors managers, and the greater its informational efficiency and liquidity. Therefore, in interpreting mandatory disclosure rules, it is important to bear in mind their purpose and the need for proportionality, that is, that they should not require of issuers more than is necessary to support liquidity and price accuracy.

Finally, EU securities regulation has its own *idiosyncrasies*. These stem from the history and architecture of EU law. There is nothing in the EU treaties that specifically refers to securities regulation and its various objectives and rationales. Historically, the main driver of EU legislation has been market integration. This historical accident (or rather, this quintessential tenet of the EU itself), similarly to what has been the case with competition law,[63] has uniquely shaped EU securities markets legislation as a market integration tool.

Relatedly, another peculiar feature of the production of EU securities regulation is the role of the European Commission as a political (or rather institutional) entrepreneur tasked with creating a single market through law: in this like in many other areas, the Commission has been pivotal in pushing in the direction of expanding the scope of EU law, occasionally with the support of the CJEU.[64]

After capital restrictions were lifted in the 1980s, the rules governing securities markets still differed widely across Member States, effectively acting as non-tariff barriers to market integration. Mutual recognition alone was not a viable strategy to counter Member States' protectionism because its implications, namely regulatory competition and cross-border spillovers, were politically unacceptable.[65] Therefore, the European Commission launched an ambitious, and still ongoing, harmonisation programme: a single rulebook that, in cooperation with the European Parliament and the Council, it superimposed on Member States' domestic

[63] See Pablo Ibáñez Colomo, 'The Evolution of EU Antitrust Policy: 1966–2017', *Modern Law Review* 83, 321, 331-32 (2020).
[64] See Ch. 2.
[65] Kelemen (n 51) 96.

laws. Initially, EU law pursued, however patchily, the model of mutual recognition coupled with minimum harmonisation rules.[66] As that model proved ineffective to fully integrate EU securities markets, the EU legislator has increasingly enacted 'maximum' and much more detailed harmonisation.[67] In many core areas of securities regulation, this more centralised approach has effectively pre-empted Member States' ability to maintain or introduce additional rules (so-called *goldplating*), which could hinder the free provision of financial services and the movement of capital in the internal market.

Market integration is just the main example of an idiosyncratic EU legislative goal that might complement, if not conflict with, investor protection, market efficiency, and even competition. Other examples include consumer protection, together with the goals of equality and fairness often derived from it, all of which are potentially in conflict with financial market efficiency. For instance, investors' equal access to information sounds fair but may undermine informational efficiency, which indirectly protects investors but requires subsidising professionally informed traders and protecting the returns on their costly search for, and legitimate use of, price-sensitive information. These idiosyncrasies raise the question of how to interpret securities regulation in the presence of goals that a rigorous economic analysis of securities regulation would put aside because they contrast with market efficiency and competition and, hence, indirectly, with investor protection as well.

Throughout this book, we provide a pragmatic answer to this question.[68] First, we acknowledge that some higher-order legislative goals may shape regulation in ways that hinder the efficient functioning of EU securities markets. That makes the understanding of the economic implications of 'goal-deviant' regulation more, not less, important. Flagging the costs of pursuing non-economic goals allows interpreters and enforcers to deviate from an efficiency-minded regulatory framework no more than is strictly required.

Second, ignoring the efficiency of financial markets, including of securities markets, may itself undermine the pursuit of non-economic goals. Because efficient financial markets make it easier for anyone with a good idea to get funding, they support social mobility.

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[66] Luca Enriques and Matteo Gatti, 'Is There a Uniform EU Securities Law After the Financial Services Action Plan?' 14 *Stan J L Bus & Fin* (2008).

[67] This move was inspired by the Final report of the Committee of Wise Men on the Regulation of European Securities Markets, 15 February 2001, chaired by Alexandre Lamfalussy, available at http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf.

[68] Cf Roberto Pardolesi, 'Law and Economics in Italy: Some Thoughts About the Academic and Judicial Reception of EAL', 23 *History of Economic Ideas* (2015).

Conversely, inefficient financial markets perpetuate entrenchment and rent-seeking by the wealthiest through fragmentation and other restrictions of competition.[69]

One final reason to interpret securities regulation through an economic lens is that seemingly non-economic goals of securities regulation, such as sustainability, can often be framed in terms of efficiency, making them easier to integrate into the functioning of securities markets.[70]

[69] Raghuram Rajan and Luigi Zingales, *Saving Capitalism from the Capitalists* (Crown Business 2003) Ch 1.
[70] See eg Oliver Hart and Luigi Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value', *Journal of Law, Finance, and Accounting* (2017).

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