

CURRENT ISSUES REGARDING THE PROTECTION OF RETAIL INVESTORS ON THE CAPITAL MARKET WITHIN THE EUROPEAN UNION

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Abstract:

In recent years, policymakers have paid increasing attention to the investor protection issue within the financial markets, which can be considered the backbone of the legal architecture (including the supervisory side) that supports capital markets.

By their nature, investments in the financial market involve a number of specific risks to which investors are exposed, depending on the level of their financial education and the context provided by the authorities in the field.

The paper approaches the current stage and limits of the capital market investor protection within the European Union. The actual focus on stability and the diversification of funding sources through the capital market calls for an increase in the importance of investor protection, which should be seen as a core issue of the revised legal framework.

Key words: capital market, investor protection, European Union, the Capital Markets Union, European Securities and Markets Authority (ESMA).

JEL classification: E22, G19, O16

1. INTRODUCTION: INVESTORS IN THE CAPITAL MARKET - BEHAVIORS AND RISKS

The principle of investor protection is one of the fundamental principles outlining the capital market law (Duțescu, 2013). Compliance with this principle requires equality between investors, market transparency, regulation and supervision.

Being a capital investment act, the acquisition of a security (share, bond, etc.) essentially involves a capital transfer to an organization, expecting a return on the risk assumed by the investor (Caraganciu et al., 2005).

An investor may be any person (natural or legal) who has entrusted money or financial instruments to an intermediary (investment firm or credit institution) for the purpose of providing investment services or an investment management company for the purpose of managing individual investment portfolios (FCI, 2017).

On the capital market, there are *two categories* of investors (Olteanu, Vlad, 2007):

- professional investors (qualified as such, in Romania, according to Law no. 297/28th June 2004 on the capital market, with subsequent amendments and completions): they have experience and specialized knowledge, being qualified for investment decisions and assessment of associated risk.

This category includes various types of *entities* authorized to operate within the financial markets (credit institutions, investment companies, collective investment entities and their management companies, pension funds and their management companies, other institutions such as: national governments, central banks, international and supranational institutions, etc.).

- individual (retail) investors: two subcategories can be distinguished as follows:
 - large investors (also called institutional investors);
 - small investors.

The importance of individual investors participation in the securities markets is derived from the need to ensure market liquidity, in addition to the diversification component, which is a condition of a healthy and strong market, given that a market dominated by professional investors can become limited or even subject to risk.

The usefulness of individual investors on the capital market is also given by (Olteanu, Vlad, 2007):

- their tendency to maintain their position for longer periods of time, resulting in the protection of issuers against excessive quotations;
- in the long run, they have the role of balancing the shareholder structure within a company.

Analyzing the specifics of the financial services consumer (investor), it can be appreciated that in the context of an investment decision, a number of *factors* intervene in the formation and manifestation of capital market behaviors:

- motivational factors: investor's personal expectations, personal confidence;
- behavioral factors: attitudes (derived from educational and environmental factors), the appetite for risk, manifest behavior (the concrete way of action in a given situation);
- economic factors: available revenue, financial planning (expected revenues), potential losses;
- factors of the external environment.

A relevant feature of capital market investments lies in the uncertainty of the effects, in terms of size and timing of their occurrence. Investors' reluctance is derived from two *components*:

- the difficulty of persuading investors to give up the convenience and momentary benefits of their own savings, in the perspective of possible gains in the future;
- the difficulty in persuading investors to invest in capital market financial products to the detriment of financial products offered by other players on the financial market: banks, insurance companies, etc. Thus, the investor must be motivated to give up future safe gains, having a fixed maturity, with minimal risk, in favor of investing in the capital market, which could yield returns proportional to the assumed risk but also the risk of losing the initial investment.

The investor's motivation is based on two components: the dividend gain and the gain determined by the market value increase comparing to the purchase price.

The financial risk assumed by the investor is determined by the context of circumstances in which an unwanted event has a certain probability of occurrence or when the size of the event has a certain distribution possibility (Caraganciu et al., 2005).

The usual risks that an investor assumes - depending on his aversion to risk - include (especially for private individual investors):

- the optional risk - given by choosing a security to the detriment of others, which may have superior performance;
- the risk of the moment - derives from the possibility of registering losses by inappropriately choosing the moment of sale or purchase;
- the market risk - associated with uncertainty about future levels of quotations as a result of changing investor attitudes;
- the risk of vendibility - closely related to liquidity, depends on the ability to sell securities without significant negative price variations.

As in the wider sphere of consumer protection, information and education - which can become self-protection tools - play a decisive role in the behavior of investors on the capital market.

One of the ways of indirect protection of investors lies in ensuring their right to information by issuers providing relevant information, according to the legal provisions.

In a study aimed at comparing financial market regulations for the protection of minority shareholders in different countries (Jardak, Matoussi), it is underlined that in recent years, regulators, academics and professionals have focused on corporate governance as a solution for limiting inadequate management behaviors, including within the capital market. As a result, different regulations and reports across the world have responded to the need to restore confidence,

to strengthen investor protection against opportunistic managers behaviors, to increase corporate responsibility and to combat fraud.

An essential part of investor information on the capital market consists in the launching of alerts / warnings by competent bodies, globally (e.g. IOSCO), regionally (e.g. ESMA in the EU) and at domestic level (ASF, in Romania).

2. ADDRESSING INVESTOR PROTECTION GLOBALLY AND IN THE EUROPEAN UNION

At international level, The International Organization of Securities Commissions (IOSCO) carries out relevant activities in this area, being an international body that brings together global regulators in the field of securities and setting out the global standards for this sector. IOSCO develops, implements and promotes compliance with internationally recognized securities standards, working closely with the G20 and the Financial Stability Board (FSB) on the global agenda for reforming these regulations (IOSCO, 2017).

Regarding investor protection, there is a special section dedicated to this topic on the IOSCO website, which includes (IOSCO, 2017):

- a portal containing alerts for investors;

IOSCO receives alerts and warnings provided voluntarily by IOSCO members regarding firms that are not authorized to provide investment services in the jurisdiction that issued the alert or warning. Some alerts or warnings refer to unauthorized companies that use similar names to those of authorized or to unauthorized firms that falsely claim to be associated with authorized firms, creating confusion for investors. The portal indicates the date when the alert or warning appeared in the list and allows access to the text on the IOSCO member web page, but does not provide a complete list of alerts and warnings launched by IOSCO members.

- a series of advices for investors;

Investors are advised to always verify - before investing - that the investment firm is regulated and authorized by the competent national authorities and to acknowledge the rights they are entitled to, complaints procedures and clearing schemes for the area where the firm is regulated. Investors are also advised to be aware of alerts and warnings that are usually available on the website of each regulator, especially if they suspect fraud or other illegal investment activities.

At present, as investments are no longer the exclusive attribute of privileged members of society, consumers are increasingly exposed to various financial risks. In this context, a number of rules have been adopted within the European Union (EU) to ensure that retail products are tailored to the needs and interests of consumers. The basis for this protection consists of providing clear and sufficient information, in accordance with the characteristics and needs of the target audience, by all actors involved.

Thus, the EU aims to maintain high standards to ensure market integrity, financial stability and investor protection, taking into account the wider global context.

Seeking a solution to create a true single capital market for all 28 EU Member States, in September 2015 the Capital Markets Union (CMU) was launched as an action plan to stimulate business finance and investment finance, based on the following key-principles (European Commission, 2015):

- creating more opportunities for investors;
- ensuring the link between funding and the real economy;
- promoting a stronger and more resilient financial system;
- deepening financial integration and increasing competition.

A relevant role in this context lies with the European Consumer Organization (BEUC), which analyzes European decisions that can affect consumers with special focus on priority areas (including financial services).

The plan does not explicitly address the issue of investor protection, as BEUC has noted in its initiatives. While the Commission seems to recognize that retail investor confidence remains an

important barrier to participation in the CMU, BEUC shows that initiatives to tackle this obstacle have been completely absent from EU short-term priorities (BEUC, 2015).

At the same time, the European Commission's Green Paper on the creation of a Capital Markets Union (2015) states that ensuring an effective level of consumer and investor protection is one of the key principles that should underpin the union of capital markets.

Within the EU, the European Securities and Markets Authority (ESMA) is the institution designed to improve the level of protection that benefit investors and to promote the stability and smooth functioning of financial markets. Established in 2011, based in Paris, ESMA has as its members the national authorities responsible for the securities markets of each Member State.

By its objectives, ESMA proposes (EU/ESMA, 2017):

- investor protection – to better respond to the needs of financial services consumers and strengthen their investor rights whilst recognizing their responsibilities;
- good functioning of markets - to promote the integrity, transparency, efficiency and orderly functioning of financial markets as well as sound market infrastructure;
- financial stability – to strengthen the financial system aiming to enable it to resist shocks and the emergence of financial imbalances and to encourage economic growth.

ESMA is also responsible for coordinating the measures taken by the securities supervising authorities or for adopting emergency crisis measures.

ESMA carries out four types of activities (EU/ESMA, 2017):

1. Evaluates investors, markets and financial stability risks. Through its databases and public registers and by launching alerts, ESMA provides investors with information that promotes transparency and protection.
2. Develops a single regulatory framework for the EU financial markets. ESMA develops technical standards and advises European institutions on the development of new regulations, thus contributing to the improvement of the EU single market.
3. Encourages the standardization of supervisory practices. ESMA promotes exchanges of best practice and efficiency gains for both national authorities and the financial sector.
4. Directly supervises specific financial bodies - credit rating agencies and trade repositories.

Besides regulators of the securities markets and the financial services sector, private and institutional investors and consumers are also among the beneficiaries of these activities.

Currently, the applicable legislative package - adopted following the financial crisis - is made up of Directive 2014/65 / EU ("MiFID"), together with Regulation (EU) 600/2014 (referred to as MiFIR), which together constitute the "MiFID II".

This regulatory package is set to strengthen and replace the current MiFID framework and covers securities markets, investment intermediaries and trading venues. MiFID II will enter into force in all Member States as of 3 January 2018 and seeks to strengthen investor protection both by introducing new requirements and by improving the existing ones.

In order to closely approach the aspects of the revised European financial market legislation, some entities organize seminars, summer courses, conferences for professionals in the capital markets. As an example, the Academy of European Law (ERA, 2017) organized in April 2017 a conference on "Investor Protection in the EU", focusing on:

- the impact of MiFID II / MiFIR on investor protection;
- the investors protection within the capital markets;
- insurance products and investor protection.

In 2014, in Wiesbaden, at the Investors International Conference on Shareholders' Rights in Europe 2020, Steven Maijoor, the ESMA President, explained the catalyzing role of the CMU for the development of the non-banking sector through diversifying sources of funding for the economy.

On this occasion (Maijoor, 2014), Maijoor showed that:

- CMU aims to accelerate the integration of EU capital markets for the 28 Member States in order to maximize the benefits of non-bank financial institutions' capital markets for the real economy.

- The CMU objectives cannot be achieved if they focus exclusively on the needs of financial institutions without establishing a high level of confidence for all types of investors in the financial markets.
- Diversification of sources of financing the economy can only be achieved if investors - especially retail investors - are encouraged to take part in this initiative.
- Better investor protection will increase their confidence and will gradually convince more and more investors to consider the EU capital markets as an alternative to banking solutions as a valuable option to diversify the portfolio.
- Properly informed and protected investors will take informed investment decisions based on the range of products available on the capital market, suitable for their needs. With more confidence in the markets and better understanding of the products they invest in, investors will be less prone to irrational reaction to market events or to follow so-called “flock” behaviors.

According to Maijoor, investor protection is an essential dimension of each of the four pillars of the CMU:

1. diversification of funding;
2. increasing the attractiveness of capital markets for both EU and abroad investors;
3. increasing the efficiency of the capital markets; and
4. strengthening and harmonizing financial supervision.

Maijoor acknowledges that the confidence of European investors in the financial sector is currently low, which requires sustained, constant efforts to amplify it, as the restoration of investor confidence is primarily the responsibility of the financial sector. Thus, in 2013, only 35% of retail investors were confident that investment service providers complied with consumer protection rules (Maijoor, 2014). This lack of confidence is particularly problematic in the European environment, where there is a preference for savings through bank deposits, although these placements may become inefficient because of bank fees and negative real interest.

In this context, regulation and oversight should strongly support this process of rebuilding investor confidence in financial markets. MiFID II is considered to be a major step forward to better protect investors, as the new rules address a wide range of important topics such as governance, conflict of interest, client assets protection - which will significantly improve fair treatment of investors. Moreover, MiFID II seeks to improve the level of protection offered to all types of investors (Maijoor, 2014).

From the perspective of harmonizing and strengthening supervision, this revised framework provides the conditions for implementing, applying, consistently supervising a set of core technical rules to identify risks in the system at an early stage and to be able to act effectively in emergency situations and in resolving disagreements between supervisors.

Similar ideas were reiterated in Stuttgart in 2016 at a capital market symposium (Maijoor, 2016), where the ESMA president stated that policy makers and regulators should address market failures that have an impact on the level of investor protection. On this occasion, it was stated that information and transparency - although important - are not sufficient to protect investors, and that substantive requirements need to be applied to ensure full investor protection.

Regarding the investor protection, ESMA published in April 2017 a brochure containing relevant questions and answers, outlining the practical aspects of MiFID II and MiFIR on this subject (ESMA, 2017b).

In the context of its current role, ESMA has committed itself to create the framework for a high and harmonized investor protection by ensuring adequate behavior of intermediary or advisory firms in relation to financial instruments (ESMA 2017a). It is important for investors to make informed decisions and have the certainty of being properly protected if something goes wrong.

ESMA therefore seeks to ensure that (ESMA 2017a):

- investment firms treat their clients in a fair and transparent way, putting their interests at the heart of their business models and corporate culture;
- clear and relevant information is provided to investors; and
- investors are provided with products appropriate to their needs and their investment objectives.

The investor protection elements of the MiFIR introduce specific intervention powers for ESMA and national supervising bodies which are able, under certain conditions, to temporarily prohibit or restrict the presentation, distribution or sale of a financial instrument or a type of activity or financial practice.

On its own website, ESMA has dedicated a special section for investors - "Investor Corner", which provides:

- a set of general advice for investors;
- an opportunity to verify whether the activity of an investment firm is authorized using a web link to the competent national authority;
- the possibility to file a complaint in relation to an individual firm or a competent national authority;
- alerts and publications for investors.

Launching warning alerts for investors is a useful tool to protect them, provided that they deliberately access this information - which requires the prior existence of basic financial education.

For example, a useful asset is represented by the investor warning released in February 2014 under the title "Risks of investing in complex products" (ESMA, 2014).

In this brochure, ESMA suggests to investors to verify each time that an investment firm is authorized to provide investment services because if the company is not authorized or regulated, it is more likely that it will not comply with investor protection rules, and, as a result, investors lose access to complaints or compensation schemes.

This ESMA warning was launched in the context of bank interest rates reaching a historically low level, and investment firms have responded to the demand for return on investment by offering complex investment products – different types of assets and strategies that were previously only available for professional investors.

Complex products (futures, options and other derivative instruments) entail a number of risks because:

- they are often aggressively marketed using attractive statements (examples: "absolute return", "guaranteed", "covered growth") or promise much higher returns than those available by banks. These advertising promises may prove to be misleading or may have a different meaning than originally understood.
- investors do not understand how complex products work, what are the associated risks, costs and revenues;
- complex products may require a high level of knowledge to analyze and assess risks, including active management and monitoring over time - making it difficult for retail investors.

The main messages addressed to investors (ESMA, 2104) suggest that:

- they should not invest if they do not understand the main characteristics of the product offered or the main risks associated with it, but to seek professional advice on the right investment;
- they should take into account the fact that sometimes the name of a product may not properly reflect its characteristics, avoiding the promise of "high", "guaranteed", "covered" or "absolute" profits that often prove to be misleading;
- they should take into account the situation in which they need access to the invested money before the date of liquidation of the product;
- they should understand the total costs, before investing, as these costs influence the resulting yield and some similar but less complex products may be available at lower costs.

According to the ESMA warning, a financial product can be considered complex when:

- it is a derivative financial instrument or incorporates a derivative (the value of which is based on the value of another financial instrument);
- it has indices or underlying assets that are not easy to evaluate or whose prices or values are not publicly available;
- it has a fixed investment duration (example: penalties in the case of early withdrawal which are not clearly explained).

The ESMA's 2014 warning also presents the main *risks and disadvantages* of investing in complex products, which must be known and, where appropriate, assumed so that investment decisions are made in an informed manner:

- the liquidity risk: refers to the impossibility of easily selling the product, if necessary, before the expiration of its term. The lack of liquidity determines either the sale of the product with a significant reduction from the purchase price or the impossibility of selling.
- the „leverage effect” risk: refers to those ways or strategies to multiply potential gains and losses (examples: borrowing, using derivative financial instruments).
- the market risk: is the current risk of losses from market price developments. Market risk increases as a result of investing in different markets of the support asset (examples: shares, interest rates, exchange rates, commodities).
- the credit risk: derives from the risk of insolvency of the product issuer or of an associated company so that the reimbursement of the investment becomes impossible. The rating provided by credit rating agencies may suggest the issuer's likelihood of becoming insolvent, but cannot guarantee that the investment will generate the expected return.
- the cost of complexity: it is associated with the degree of complexity of the financial product, and there may be additional costs for the product's support features (or fees and commissions already included without being explicit).

3. LIMITS OF THE CAPITAL MARKETS UNION REGARDING INVESTOR PROTECTION IN THE EUROPEAN UNION

Research and recommendations included in a report drafted by the European Investors' Working Group (EIWG, 2010) reveal that all capital market participants should assume a set of principles of accountability and transparency in the context of the current priority of ensuring financial stability. Thus, in order to restore investors' confidence after the financial crisis, it has become necessary to review, supervise and adequately regulate capital markets by identifying, measuring and controlling systemic risks. The study (EIWG, 2010) proposes the following:

- taking into account the limitations of European rules, investors also must carry out their duties as responsible owners by actively supervising the governance and strategies of financial institutions;
- investors need to focus more resources on diligent investigation and monitoring of their investments, on seeking ways of cooperating with other investors to hold issuers accountable for governance matters;
- European institutions need to invest more resources to streamline investor voting processes and to promote financial education, providing greater protection for retail investors.

The EIWG Group believes that the EU agenda should focus primarily on restoring investor confidence, listing six main objectives which should be pursued by the European institutions (EIWG, 2010):

1. Investor protection;
2. Better transparency;
3. Market integrity;
4. Market efficiency;
5. Quality of surveillance and
6. Competitiveness of EU markets.

Achieving these objectives does not only entail the development of new regulations, but should also include the elimination of current gaps and the harmonization of rules and the supervision of the capital market in Europe.

In relation to the first objective - investor protection - the EIWG underlines the negative impact of the financial crisis on the confidence of European investors (at both institutional and retail level). This has led to a low participation of retail investors in the financial markets, with a negative effect on the value of direct and collective investment. Since investor confidence is an essential

component in the efficient operation of capital markets, a way to restore it is precisely its consolidation. Thus, the EIWG considers that investor protection should be seen as one of the pillars of determining the evolution of the European agenda for the supervision and regulation of the capital market.

Recent developments in financial markets have highlighted how the sale of financial products to retail investors has been influenced by the imbalanced tax structure and compensation mechanisms. In some cases, such clearing mechanisms compromise the ability of investment consultants to prioritize customer interests, having - as professionals - a fiduciary duty towards their clients. The sale of financial products should be based on an in-depth assessment of the investment objectives, risk profile and financial constraints of customers.

For retail investors, it is often difficult to assess the adequacy of an investment product before its acquisition and to critically evaluate its performance. Moreover, retail investors do not have the experience or familiarity with the legal issues needed to identify incorrect practices (e.g. hidden costs). In this context, the EIWG supports the idea of improving the financial culture at Member State level to combat non-conforming practices.

Since, within the EU, shareholders do not benefit from homogeneous corporate governance rules, a balanced approach is required so that shareholders have the appropriate means to express their views and exercise their rights without affecting the efficient management of companies.

The EIWG believes that promoting a culture of best practice exchange would act as a catalyst for better governance within the European Union.

The PriceWaterhouseCoopers report on CMU (PWC, 2015) reveals that this initiative involves some risks, including market volatility that can increase systemic risks, reduce the ability of small / local players to access funding, and weaken investor protection, in some cases, as a result of the harmonization process.

In a study published in 2015, Ureta (Gasos et al., 2015, pp. 43-51) shows that detailed and complex information on financial products can have only limited value in protecting retail investors, while providing financial education to investors, and avoiding the use of confusing names for financial products may be more efficient. The author points out that the need for financial education is particularly evident in an environment of zero interest rates for secure assets.

Ureta (2015) also claims that investors should know that "Eldorado does not exist", understanding that the return involves accepting risk (risk implications being difficult to understand when investing in complex financial products). Thus, integrating financial education into business models should be a priority for financial institutions and for the financial industry as a whole.

A series of signals from the Financial Conduct Authority (FCA) – the UK market regulator (Jones, 2015) - draws attention to the fact that EU plans to stimulate funding through the market risk harming consumers if there is not enough emphasis on investor protection.

Martin Wheatley, former CEO of the FCA, stated that CMU aims to facilitate companies' access to equity and bond markets, rather than relying mainly on bank lending - as many companies in Europe are still doing so today - without ensuring a fair balance between the need for economic growth and the investors protection.

Wheatley argues that avoiding consumer protection is not viable in the long run, as CMU will not succeed if profit becomes the main driver of behavior, as it was in the preceding period to the financial crisis.

As a solution, while CMU is an EU initiative, internal regulating authorities should be able to protect consumers by restricting the marketing or reducing the supply of new products for certain consumers, along with improving information on financial products and services.

A recent study (Valiante, 2016) proposing a series of recommendations in the context of the CMU shows that the lack of a pan-European agency for consumers, which could provide a unique framework for the consumers protection, is a barrier to financial reform. The author suggests that such an agency could support the coherent application of national consumer laws by limiting the proliferation of local supervisory approaches and would provide more investor protection tools through closer monitoring and easier access to the applicable tools in case of harmful practices. It is

proposed that this agency should operate under the ESMA supervision, whose mandate covers the protection of investors and investment service users.

On the other hand, the European Commission (Green Paper, 2015) considers that European supervising authorities can play a role in increasing convergence, given that national supervisory systems can lead to different levels of investor protection which create barriers against cross-border operations and may discourage businesses seeking funding in other Member States.

CONCLUSION

Capital markets operate efficiently when they attract capital and investors, allowing for an efficient allocation of resources, aimed at boosting economic growth and prosperity. As a result, market integrity and investor protection are of paramount importance.

At EU level, investor protection is considered at the same time a factor that facilitates the diversification of financing sources for the economy, but also one that contributes to its stability, based on the new revised legal framework, which requires consistent application of the same rules and the use of similar approaches within the 28 Member States.

At present, although the need for strong investor protection – especially for the retail investors sector - is clearly formulated at the theoretical and political level, its concrete application does not yet benefit from the necessary framework, due to limitations such as insufficient financial education, lack or gaps in national legislation, the existence of incorrect market practices, insufficient or inadequate compensation mechanisms.

Building an integrated and efficient capital market is necessary, provided that due attention is given to the imperative of investor protection.

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