<u>Biased Financial Advisers, Regulation, and Transparency</u>

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We study the effects of transparency and investor sophistication over the incentives of a financial adviser to provide honest and suitable financial advice to partially informed consumers. The novel aspect of our analysis is the inclusion of courts as a costly mechanism to provide incentives to reduce incorrect advice, where the cost arises from judicial errors due to imperfect evidence. We show that the cost of using courts to provide appropriate incentives is decreasing in investor sophistication and transparency. However, the judicial system may not be able to implement the first best without appropriate regulation when advisers can choose their level of transparency. In such a case, advisers with strong incentives to provide incorrect advice may be tempted to reduce transparency if it increases the prevalence of judicial error. The analysis sheds lights on the structure of legal duties of investment services firms, such as those under the recent European MiFID II scheme.