Financial Law Institute

Working Paper Series

WP 2005-07

Marc KRUITHOF

Conflicts of Interest in Institutional Asset Management: Is the EU Regulatory Approach Adequate?

December 2005

WP 2005-07

Marc Kruithof

Conflicts of Interest in Institutional Asset Management: Is the EU Regulatory Approach Adequate?

Abstract

This article seeks to contribute to the discussion concerning the adequacy of the legal responses to conflicts of interest in institutional asset management. After defining the legal concept of a conflict of interest in general, the insights of economic theory, especially agency theory, are called upon to pinpoint the reason why such conflicts are a problem that warrants special legal attention. Possible conflicts of interest faced by professional asset managers are identified and the reasons why the problems caused by these conflicts warrant specific government intervention are discussed. The article then describes what the legal responses to conflicts of interests problems in asset management have been, in particular in the new European Market in Financial Instruments Directive (MiFID). These responses are then analyzed taking into account the elements that economic theory show to be the key characteristics of the conflicts of interest problem and conclude that these legal responses address the problem from the wrong perspective and hence are lacking in certain critical respects.

To be published in

LUC THÉVENOZ & RASHID BAHAR (ed.), *Conflicts of Interest and the Duty of Loyalty* (working title), forthcoming in 2006

Instituut FINANCIEEL RECHT FINANCIAL LAW Institute

© Financial Law Institute, Universiteit Gent, 2005

UNIVERSITEIT GENT

Conflicts of Interest in Institutional Asset Management: Is the EU Regulatory Approach Adequate?

MARC KRUITHOF [*]

I. Introduction ... 1
II. Conflicts of Interest in General ... 2
A. Conflicts of Interest as a Legal Concept ... 2
B. Conflicts of Interest as an Economic Agency Problem ... 6
III. Conflicts of Interest in Asset Management ... 11
A. The Inevitability of Conflicts of Interest in Institutional Asset Management ... 11
B. Possible Conflicts of Interest for Portfolio Managers ... 12
1. Conflicts Because the Manager Has Several Clients ... 13
2. Conflicts Because the Manager Also Offers Other Services ... 14
3. Conflicts Because the Manager Has a Stake in the Consequences of Transactions ... 17
C. Resulting Agency Costs for Asset Management ... 18
1. Adverse Effects to the Interests of the (Small?) Investor ... 18
2. Undermining Capital Market Integrity ... 21
3. Suboptimal Asset Management Market Efficiency ... 23
IV. Legal Approaches to Conflicts of Interest in Asset Management ... 24
A. Imposing Fiduciary Duties ... 24
B. Regulatory Conduct of Business Rules ... 28
1. A Regulatory General Standard of Loyalty ... 28
2. Imposing Specific Rules for Asset Management Services? ... 31
3. Specific Requirements of Suitability of Investment Decisions ... 34
4. Client Order Handling Rules ... 36
C. Specific Measures to Tackle Conflicts of Interest ... 39
1. Which Conflicts of Interest? ... 40
2. Structural and Organizational Measures ... 41
3. Disclosure Requirements ... 43
V. Some Concluding Remarks ... 49

[*] Lecturer in Law at the Department of Business Administration and Public Management of the Hogeschool Ghent (Belgium), Assistant at the University of Ghent Law School and the Financial Law Institute (Belgium); Licentiate in Law, University of Ghent (Belgium); Licentiate in Economics, University of Ghent (Belgium); LL.M., Yale Law School (USA).

marc.kruithof@hogent.be – marc.kruithof@ugent.be

I. Introduction

1. Conflicts of interest, especially those present in the financial sector, have been debated for some time and regulators have introduced various rules, principles and mechanisms specifically intended to address such conflicts.[1] This article seeks to contribute to the discussion about the adequacy of these legal responses to conflicts of interest in institutional asset management or delegated portfolio management.[2] This issue is approached from a theoretical perspective by analyzing whether the typical legal responses to such conflicts, in particular those envisaged under the new European Market in Financial Instruments Directive (hereinafter "MiFID"),[3] address the elements that economic analysis has shown to be the key characteristics of the problem.

2. Section II of the paper begins by analyzing the concept of a conflict of interest in general. After defining the legal concept, the insights of economic theory are called upon to pinpoint the reason why such conflicts are a problem that warrants special legal attention. Section III focuses on asset management, first identifying the possible conflicts of interest portfolio managers can be confronted with in Subsection III.A., and then justifying why the problems these conflicts might cause call for government intervention in Subsection III.B. Section IV discusses how the law has dealt with conflicts of interest in asset management. Section V gives some concluding remarks, taking into account recent developments in the market of asset management.

---

1 For EU regulation of the financial sector, *see e.g.* Articles 10 and 17 of Council Directive 85/611/EEC of 20 December 1985 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS), *Official Journal*, L 375, 31 December 1985, p. 3 (hereinafter referred to as the "UCITS Directive"); Articles 10 and 11 of Council Directive 93/22/EEC of 10 May 1993 on Investment Services in the Securities Field, *Official Journal*, L 141, 11 June 1993, p. 27 (in short called the "Investment Services Directive", usually and hereinafter referred to as the "ISD"); and more recently Articles 13(3) and 18 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and Repealing Council Directive 93/22/EEC, *Official Journal*, L 145, 30 April 2004, p. 1 (in short called the "Market in Financial Instruments Directive", usually and hereinafter referred to as the "MiFID").

2 Institutional asset management can take different forms. Financial institutions manage portfolios of investments both belonging to a collectivity of investors (such as an investment company or a management company of mutual funds), usually referred to as collective asset or portfolio management, and also those belonging to individual clients (even though these clients can themselves be institutional investors, such as pension funds or investment companies or a management companies of mutual funds that have delegated the actual management of their portfolios to a specialized investment firm, so that the managed assets economically form a collective portfolio), usually referred to as individual asset or portfolio management. In this article we refer to both of these forms of delegated portfolio management together as "asset management" or "portfolio management".

3 *See supra* note 1. These rules are applicable to investment firms and banks; *see* Article 1(2), MiFID. The rules on conflicts of interest in the MiFID are most likely to become if not *de jure*, then at least *de facto*, the uniform standard in the EU, as it is unlikely that any Member State will impose additional rules addressing this problem. *See* L. ENRIQUES, "Conflicts of Interest in Investment Services: The Price and Uncertain Impact of MiFID's Regulatory Framework", to be published in G. FERRARINI & E. WYMEERSCH (eds.), *Investor Protection in Europe: Regulatory Competition and Harmonization*, Oxford: Oxford University Press, forthcoming in 2006, references here to the working paper version available in the Social Sciences Research Network electronic library, <www.ssrn.com/abstract=782828>.

II. Conflicts of Interest in General

A. Conflicts of Interest as a Legal Concept

3. In the most broad – *i.e.* non-legal – sense, a conflict of interests can be understood to be a situation in which the protection or furtherance of different interests requires different actions, in other words, circumstances in which a choice of action necessarily implies preferring certain interests over others. Modern society applies several methods to make choices among conflicting interests such as politics, law in general, contracts between individuals and as a result of competition between potential contract parties the market mechanism, etc. In this sense, everything the law deals with is in essence a conflict of interests, and the same can be said of economics.

4. But when lawyers talk about conflicts of interest, they do not mean all those situations in which the interests of different people call for different choices; the term "conflict of interest" has a much more specific meaning in a legal context.[4] In the legal sense, a conflict of interest arises when a person in a certain situation has a duty to decide how to act solely based on the interests of another person while the choice he makes also has repercussions for his own interests (*conflict of interest and duty*) or for the interests of another, third person, that he is also legally bound to protect (*conflict of duties*).[5] Both types of conflicts of interest[6] raise issues because we assume that a person normally determines how to act at least partially based on the repercussions the available alternative actions have on his own interests.[7]

5. However, the fact that someone has a personal interest in the choice he legally is required to make, is not sufficient to create a conflict of interest in the legal sense of the term. Were this to be the case, then anytime a person is under a legal duty to act in a

---

4 Note the distinction between a "conflict of interest*s*", a general concept, and a "conflict of interest", referring to the specific legal [or moral] problem studied here, as suggested by M. DAVIS, "Introduction", in M. DAVIS & A. STARK, *Conflict of Interest in the Professions*, Oxford: Oxford University Press, 2001, 3-19, p. 16.

5 *Cf.* V. SIMONART, "Conclusions générales", in M. EKELMANS, M. GREGOIRE, D. LECHIEN a.o., *Les conflits d'intérêts*, Université Libre de Bruxelles, Les conférences du Centre de Droit Privé, Vol. VII, Brussels: Bruylant, 1997, 297-326, p. 304-305; M. DAVIS (note 4), p. 8; J.R. BOATRIGHT, "Financial Services", in M. DAVIS & A. STARK, *Conflict of Interest in the Professions*, Oxford: Oxford University Press, 2001, 217-236, p. 219.

6 From this perspective, a conflict of duties does not differ from a conflict of interest and duty. The latter type of conflict is considered to be a problem because there is reason to fear that the person will not fulfill his duty when doing so would damage his own interests. The same idea is the basis for considering a conflict of duties to be problematic: abiding by one duty might imply a breach of the other duty, bringing about sanctions that adversely affect the acting person's interests.

7 For this assumption to be valid, it is not necessary that a person chooses his actions solely based on his own interests; as soon as his own interests have some influence on his actions, the situation characterized as a conflict of interest becomes problematic. For an interesting psychological view on the problem of conflicts of interest, analyzing why self-interest even subconsciously influences our actions when such actions are supposed and thought to be geared towards other interests, *see* D.A. MOORE & G. LOEWENSTEIN, "Self-Interest, Automaticity, and the Psychology of Conflict of Interest", *Social Justice Research* 17 (2004/2) 189-202. For analysis of how our so-called "bounded ethicality" leads us to insufficiently recognize situations as conflicts of interest and realize conflict of interest situations to be problematic, which as a result even more reduces the extent to which our moral sense will limit our "automatic" tendency to further our own interests, *see* D. CUGH, M.H. BAZERMAN & M.R. BANAJI, "Bounded Ethicality as a Psychological Barrier to Recognizing Conflicts of Interest", in D.A. MOORE, D.M. CAIN, G. LOEWENSTEIN & M.H. BAZERMAN (eds.), *Conflicts of Interest. Challenges and Solutions in Business, Law, Medicine, and Public Policy*, New York: Cambridge University Press, 2005, 74-95.

certain way that party would have a conflict of interest, because his personal interests always will be affected by the choice to abide by this duty or not. This arises from the fact that breaching the duty would risk sanctions, while fulfilling the duty – and thus avoiding the sanctions – represents a cost for this person as well. In this sense, a person who has a legal duty will always have interests that potentially conflict with this duty. Also, to look at it the other way around, the fact that a legal duty requires a person to act contrary to his own interests in order to protect the interests of someone else is not enough to create a conflict of interest in the legal sense of the term. All duties are intended to steer the actions of a person in order to protect the interests of others and thus "represent" the interests of others.[8] The fact that these interests of others conflict with the actor's own interests does not delineate a subset of all situations involving duties, it just characterizes every situation in which a legal duty is present, as it is precisely the reason why the legal duty is imposed in the first place.

6. So we cannot say that a person is faced with a conflict of interest just because he has a personal interest that conflicts with his legal duty, nor is a person confronted with a conflict of interest just because his freedom to further his own interests is limited by a legal duty that requires him to act in a certain way to protect the interests of others. What characterizes the situation known as a conflict of interest in the legal sense of the concept is the specific content of the legal duty the person is under, a duty which is usually referred to as a duty of loyalty.[9] Two characteristics of such a duty are particularly relevant here.

7. The first characteristic of a duty of loyalty is that the legally required action is not specifically identified: the law does not tell the person exactly what to do or how to act.

On the one hand, it is recognized that a person under a duty of loyalty has a so-called discretionary margin within which he can legally judge which action is the most appropriate.[10] Reasonable persons can disagree about which of the feasible actions within this margin would be optimal, so the fact that such disagreement exists does not imply a particular choice was wrong. Also, the fact that the action afterwards turns out

---

[8] In a minority of cases, the legal duty is intended to steer the actions of a person to protect his own interests. These kinds of duties are mainly imposed in situations where a person is not trusted to reliably protect his interests voluntarily, such as when the person is not considered to be able to form rational judgments (*e.g.* minors) or when the costs and benefits of a choice to be made are usually not correctly estimated by an individual person (*e.g.* mandatory seat belts in cars).

[9] *Cf.* A.G. ANDERSON, "Conflicts of Interest: Efficiency, Fairness and Corporate Structure", *UCLA L. Rev*. 25 (1978) 738, footnote 2 on p. 738: "The three major areas where conflicts of interest are so labeled and regulated are government, the professions and property management. […] [T]hose "conflicts of interest" recognized by lawyers are typically conflicts between self-interest and fiduciary obligations of loyalty or impartiality." In this article, the term "duty of loyalty" is used in its general, generic sense, not necessarily in the more specific fiduciary meaning as it is usually used in common law systems, with all the particular legal consequences that brings (*see infra* Section IV.A), as these special fiduciary characteristics do not constitute the *source* of conflicts of interest but are part of the law's *solutions* for the problems stemming from the conflicts of interest any duty of loyalty, fiduciary or not, creates. As discussed later, civil law systems do not know fiduciary law with all its equitable characteristics, but of course do impose duties of loyalty through various other mechanisms.

[10] *Cf.* D.A. DEMOTT, "Beyond Metaphor: An Analysis of Fiduciary Obligation", *Duke Law Journal* (1988) 879, p. 908-910; R. COOTER & B.J. FREEDMAN, "The Fiduciary Relationship: Its Economic Character and Legal Consequences", *New York University Law Review* 66 (1991) 1045, p. 1046-1047 & 1051.

not to have been the optimal choice does not in itself imply the duty was breached, as long as the choice fell within the margin of discretion, that is, the range of actions about which reasonable people could disagree what is the optimal choice. The duty how to act is in that sense open-ended, usually worded in terms of "best efforts" or "prudence" or "due care".[11] Viewed this way, a duty of loyalty encompasses a duty to act with care: it requires a reasonable effort to try to find the optimal choice of action, given the interests that have to be furthered.

On the other hand, however, a duty of loyalty is very specific, not open-ended at all, and very different from a duty to act with care. Loyalty has been described as "the willing and practical and thorough-going devotion of a person to a cause."[12] The requirement to be loyal is thus a constraint on a party's discretion to pursue self-interest,[13] prohibiting the power the person has to be used for other goals then it was intended for, *i.e.* the furthering of the interests of the beneficiary.[14] The duty requires the person to determine his way of acting *solely* or *exclusively* based on the interests of another person. In his decision making process, he has to weigh only the costs and benefits of the available alternative actions for the other person whose interests he is under a legal duty to protect, and choose the action that maximizes the interests of that person. He has to ignore – in the sense of completely not take into account – the effects the available alternatives might have on his own interests, including those resulting from his duties to other persons. A duty of loyalty thus applies to this decision making process, it is not a norm to judge the chosen action itself.[15]

8. While reasonable persons might disagree about which action is optimal for the interest that has to be protected and therefore several choices within the range of discretion might be legitimate from this perspective, reasonable persons are not supposed to disagree about which interest should be the yardstick to judge the actions taken under a duty of loyalty and therefore only one very specific motive is allowed to inspire these actions. Any, even the slightest, deviation from this principle by allowing one's choice to be influenced by an interest other than the one to be protected, implies a breach of the duty of loyalty: here, there is no margin of discretion.

The typical element that characterizes a situation as a conflict of interest, therefore, is the fact that the specific content of the legal duty is to *exclude* the person's own

---

[11] *See* R. COOTER & B.J. FREEDMAN (note 10), p. 1049.

[12] J. ROYCE, *The Philosophy of Loyalty*, p. 16 (1930), quoted in A.W. SCOTT, "The Fiduciary Principle", *California Law Review* 37 (1949) 539, p. 540.

[13] D.A. DEMOTT (note 10), p. 879.

[14] *Cf.* T. FRANKEL, "Fiduciary Duties", in P. NEWMAN (Ed.), T*he New Palgrave Dictionary of Economics and the Law*, London: Macmillan, 1998, 127-132, p. 129.

[15] *Cf.* C.M. BRUNER, "'Good Faith,' State of Mind, and the Outer Boundaries of Director Liability in Corporate Law", Boston University School of Law, Working Paper Series, Law and Economics, Working Paper No. 05-19, p. 57, available in the Social Sciences Research Network electronic library at <www.ssrn.com/abstract=832944> (October 2005): "fiduciary duty doctrine would be rendered substantially more comprehensible and workable if the line between care and loyalty were understood functionally as an analytical distinction between minimizing agency costs through assessment of the quality of objective decisions, on the one hand, and the quality of subjective intentions, on the other. Beneath the surface of the doctrine and the terminology employed, this has always in fact been the difference between the duties of care and loyalty".

interest from his decision making process, while such interests are in fact present.[16] And here lies the particular risk: when the person has the opportunity to make choices within his discretionary margin that are not exclusively motivated by their effect on the interests of the beneficiary, such behavior will be all the more likely when the person has personal interests involved.[17]

9. The second characteristic of a duty of loyalty, which is actually merely a consequence of the first, is that it is judged by a subjective standard, that is, only concerned with the *ex ante* motive or the purpose the action should be aimed at, not the *ex post* effects this action might actually turn out to have. But while the effects of an action very often are objectively verifiable, the actor's intentions usually are not. In most instances, the intentions of the actor cannot *ex post* be deduced from the results of the action. Not only are the effects of actions in most cases not completely determined by these actions but also influenced by external factors,[18] but also the existence of a margin of discretion within which reasonable persons can disagree about which action is optimal given the stated purpose creates a problem. A certain outcome can be the result of a choice of action within the acceptable range inspired exclusively by the interest to be served, but that same outcome might very well be the result of a choice of another action within the same range but which was preferred above other actions because it also served another, conflicting interest.[19] *Ex post*, it is very hard if not impossible to distinguish between these two actions, but while both actions are within the margin of discretion, only one of them is a legitimate choice in light of the duty of loyalty.[20]

10. As a result, the enforcement of a duty of loyalty is extremely difficult. As the person with the duty of loyalty can substantially gain from wrongdoing, the low risk of

---

[16] *Cf.* M. DAVIS (note 4), p. 4: "Conflict of interest is a problem only in a certain domain, one in which we do not want ordinary self-interest to guide the decisions of those on whom we depend; instead we want those on whom we depend to be 'independent', 'impartial', 'unbiased' or the like."

[17] *See* T. FRANKEL, "Fiduciary Law", *California Law Review* 71 (1983) 795, p. 809-810; K.B. DAVIS, Jr., "Judicial Review of Fiduciary Decisionmaking – Some Theoretical Perspectives", *Northwestern University Law Review* 80 (1985) 1, p. 4.

[18] In economic literature this is often referred to as a "high-noise, low-signal environment".

[19] *Cf.* R. COOTER & B.J. FREEDMAN (note 10), p. 1049-1051.

[20] One could wonder why, if the harm done to the person the duty is owed to is not affected by whether a particular choice of action is due to a lack of care or a lack of loyalty, the law should treat both instances differently. *Cf.* A.G. ANDERSON (note 9), footnote 59 at p. 758: "Disloyalty may be intuitively regarded as more "unfair" because it involves a somewhat more deliberate form of self-preference than laziness or carelessness, but both the careless and the disloyal [person] are choosing self-interest […] over the duty to others. Negligence and self-dealing are equally costly to the person harmed, and I therefore include both in my discussion of cheating by fiduciaries." However, while the harm to the principal might be the same whether the person under a duty is negligent or disloyal, the harm to society is not. The reason why the law should treat a breach of a duty of loyalty differently from a breach of a duty to act with care is partially the same one would give to the question why a distinction is made between mere incompetence or lack of care and fraud. To increase a level of competence or of care, an investment of real resources has to be made. Here, as always, a legitimate question can be asked whether these resources would not be better allocated elsewhere. A reduction in fraud or an increase in loyalty, however, does not require any additional resources. An adherence to honesty would thus always involve a clear social gain, while an increase in competence or care will only yield a social gain to the extent that the gains are greater than the increase in resource costs. *See* M.R. DARBY & E. KARNI, "Free Competition and the Optimal Amount of Fraud", *Journal of Law and Economics* 16 (1973) 67, p. 83.

being caught means that there is a much stronger than standard incentive to breach a duty of loyalty, explaining the special legal attention paid to this phenomenon.[21]

B. Conflicts of Interest as an Economic Agency Problem

11. In economic parlance, a person acting in a way that affects the interests of another person or other persons is referred to as an "agent"; the person whose interests are affected by the act of the agent is referred to as the "principal".[22] In most instances, an agent will also have personal interests relating to his actions that affect others, and those interests might differ from the principal's or, to put it more precisely, those interests might be better served by a way of acting that does not have optimal consequences for the interests of the principal. From a utilitarian perspective, the socially optimal action is the one that maximizes the aggregate utility – interest furtherance – for the principal and agent jointly.[23] Assuming no legal duties are present, economic theory predicts that the agent will act as if he is only trying to maximize his own interests involved, not taking into account the consequences of his actions for the interests of the principal and thus not realizing a social optimum.

12. One way of overcoming this problem is for the principal to bargain with the agent: in return for the agent choosing the action that satisfies the principal, the principal will pay the agent an amount that renders it in his interest to act that way.[24] Such transactions will lead to a social optimum, classic economic theory predicts, as it assumes that both principals and agents will only and always consent to such deals if they make them better off. The problem of the conflicting interests of people, therefore, automatically disappears if the market is allowed to do its wonders, classic economic theory

---

[21] *Cf.* A.G. ANDERSON (note 9), p. 740: "Special legal regulation of conflicts of interest is imposed on those occupational groups which have the greatest opportunities to cheat without detection and whose cheating imposes the most serious costs on others."

[22] Note that the terms agent and principal are used here without necessarily implying the legal relationship as exists between a legal principal and agent; legal agents and principals are also economic agents and principals, but the latter category is much broader. *See* in general J.W. PRATT & R.J. ZECKHAUSER, "Principals and Agents: An Overview", in J.W. PRATT & R.J. ZECKHAUSER (eds.), *Principals and Agents: The Structure of Business*, Boston Massachusetts: Harvard Business School Press, 1985, 1-35, p. 2; for a description of the possible principal-agent relationship present in asset management services, *see* BANK FOR INTERNATIONAL SETTLEMENTS, *Incentive Structures in Institutional Asset Management and Their Implications for Financial Markets*, Committee on the Global Financial System Working Group Report No. 21, Basel: BIS, March 2003, p. 16-18.

[23] This would be the so-called Kaldor-Hicks efficient result. This concept of efficiency is based on N. KALDOR, "Welfare Propositions of Economics and Interpersonal Comparisons of Utility", *Economic Journal* 49 (1939) 549-552 and J.R. HICKS, "The Foundations of Welfare Economics", *Economic Journal* 49 (1939) 696-712.

[24] Other methods are also used to overcome this problem, such as the legal system imposing duties or liabilities not based on contract on agents to provide them with incentives to take the interests of principals into account. However, given that the focus of this paper is on asset management, a contractual relationship, we restrict ourselves here to deals. For an enjoyable introductory overview of possible applications of the economic agency model to very different areas of the law, *see* E. POSNER, "Agency Models in Law and Economics", in E. POSNER (ed.), *Chicago Lectures in Law and Economics*, New York: Foundation Press, 2000, 225-243, who on p. 240 writes that "Once one has mastered the agency model, it is a fine game, especially on long car trips, to apply it to everything in the universe."

told us:[25] a social optimum would necessarily result.[26] In other words, classic theory did not perceive the principal-agent relation to be a "problem", so little attention was devoted to it.

13. Insights developed during the latter half of the twentieth century and usually referred to as information economics seriously challenged this view. Classic economic theory starts from the assumption that agents and principals have perfect information, not only about their own interests, but also about how potential alternative actions will affect those interests and about what actions actually take place and have taken place. Of course, this condition rarely corresponds with reality. For a long time economists had assumed that markets with not too imperfect information would perform very much like markets in which information was perfect, rendering the actual imperfection of information a minor "noise", not threatening the validity of the theory and the accuracy of its predictions. Information economics, however, showed that even a very small amount of information imperfection could result in outcomes *very* different from what classic theory predicts.[27] Agency theory was developed to analyze the problems caused by information asymmetry between a principal and an agent.[28]

14. The classic theory's prediction that the market will solve any conflict of interest problem only holds on the assumption that the person under the duty of loyalty will actually fulfill this duty completely and correctly and if not, the law imposes a sanction or provides the principal with an effective remedy.[29] But for this to be possible, the principal has to know whether the agent has correctly performed his duty, which is difficult as the agent's duty applies to the motives for, rather than the outcome of, his actions. Such a duty is difficult to police in practice, because the agent's intentions are only known to him.[30]

---

[25] *Cf.* the formulation by ADAM SMITH in *An Inquiry into the Nature and Causes of the Wealth of Nations* (first published in 1776): "by [acting] he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end [a social optimum, MK] which was no part of his intention."

[26] This is the so-called first optimality theorem, according to which if a competitive equilibrium exists and if all commodities relevant to costs or utilities are in fact priced in the market, then the equilibrium is necessarily optimal in that there is no other allocation of resources to services which will make all participants in the market better off. *See* K.J. ARROW, "Uncertainty and the Welfare Economics of Medical Care", *The American Economic Review* 53 (1963) 941, p. 942.

[27] *See* J.E. STIGLITZ, "Information and the Change in the Paradigm in Economics, Part 1", *The American Economist* 47 (2003) 6, p. 8.

[28] *See* in general K.M. EISENHARDT, "Agency Theory: An Assessment and Review", *Academy of Management Review* 14 (1989) 57-74; K.J. ARROW, "The Economics of Agency", in J.W. PRATT & R.J. ZECKHAUSER (eds.), *Principals and Agents: The Structure of Business*, Boston Massachusetts: Harvard Business School Press, 1985, 37-51; H.R. VARIAN, *Intermediate Microeconomics – A Modern Approach*, New York – London: W.W. Norton & Company, 6th edition, 2003, Chapter 36, p. 667 *et seq*.

[29] As E.N. WHITE correctly points out, "[l]itigation is an important part of market discipline"; *see* his "Quis Custodiet Ipsos Custodes? Controlling Conflicts of Interest in the Financial Industry?", in C. BORIO, W.C. HUNTER, G.G. KAUFMAN & K. TSATSARONIS (ed.), *Market Discipline across Countries and Industries*, Cambridge, Mass.: The MIT Press, 2004, 287-300, p. 296.

[30] *See supra* paragraph 9. *See also* R. COOTER & B.J. FREEDMAN (note 10), p. 1051, footnote 13, referring to R. ROMANO, "The Dynamics of Shareholder Litigation: An Empirical Study", unpublished manuscript, 1990; *cf.* R. POSNER, *Economic Analysis of Law*, Boston & Toronto: Little, Brown and Company, 3rd edition, 1986, p. 418 about the paucity of litigation about trustees' investment decisions because most trust instruments give the trustee a discretionary power.

In most cases the actual motives for the agent's actions cannot be deduced from the objective outcome of these actions. First, it is possible that this outcome itself is impossible to ascertain. For example, if the task of the agent is to avoid losses as much as possible, it is very difficult to quantify *ex post* the amount of losses that were actually averted.[31] Second, in many cases the objective outcome is not exclusively determined by the agent's actions but also influenced by external factors.[32] To complicate matters further, enforcing a duty of loyalty through the legal system requires the beneficiary to be able to convince a court that a breach has occurred. It is not enough for the principal to "know" what the agent's motives were, he also has to be able to prove it.[33]

If for any of these reasons the assumption of classic economic theory is not realistic, a problem develops which in modern economic literature is usually referred to as a *moral hazard*: the agent with conflicting motives has an incentive to undertake a *hidden action* with adverse consequences for the principal, and market forces alone do not suffice to avoid this problem.[34]

15. But can't we assume that principals prefer "moral" agents over "rational" agents,[35] *i.e.* that over time principals will learn from past experiences giving dishonest agents a bad reputation that will force such agents to accept lower prices, allowing for a discount that compensates the customers for the eventual disloyalty *ex ante*, and that in the end the market mechanism will thus be able to deal with this problem by rendering only loyal behavior rational, also from the agent's perspective? There are situations where this might work, but unfortunately more often this is not the case when the problem is a conflict of interest in the narrow legal sense used here. In those situations, the principal does not know in advance whether his agent will be loyal and thus cannot negotiate *ex ante* compensation from disloyal agents, thereby providing effective incentives for agents to behave honestly.[36]

16. In many cases of moral hazard no bad reputation can develop or attach precisely because of the informational problems that created the moral hazard in the first place.[37]

---

[31] W. BISHOP & D.D. PRENTICE, "Some Legal and Economic Aspects of Fiduciary Remuneration", *Modern Law Review* 46 (1983) 289, p. 290 & 292.

[32] *See* W. BISHOP & D.D. PRENTICE (note 31), p. 290; K.B. DAVIS, Jr. (note 17), p. 6; R. COOTER & B.J. FREEDMAN (note 10), p. 1049-1051.

[33] *See* J.-J. LAFFONT & D. MARTIMORT, *The Theory of Incentives – The Principal-Agent Model*, Princeton and Oxford: Princeton University Press, 2002, p. 3, referring to this type of information problem as "nonverifiability".

[34] *Cf.* L.S. FRIEDMAN, *The Microeconomics of Public Policy Analysis*, Princeton & Oxford: Princeton University Press, 2002, p. 260-261 & 729-730.

[35] While moral hazard had been considered only as a moral or ethical problem by most writers, it is Pauly who first explicitly pointed out that it is "a result not of moral perfidy, but of rational economic behavior." *See* M.V. PAULY, "The Economics of Moral Hazard: Comment", *American Economic Review* 58 (1968) 531, p. 535. As a reaction, Arrow correctly stressed that "Mr. Pauly's wording suggests that "rational economic behavior" and "moral perfidy" are mutually exclusive categories. No doubt Judas Iscariot turned a tidy profit from one of his transactions, but the usual judgment of his behavior is not necessarily wrong." *See* K.J. ARROW, "The Economics of Moral Hazard: Further Comment", *American Economic Review* 58 (1968) 537, p. 538.

[36] K.B. DAVIS, Jr. (note 17), p. 6-7 and 44; W. BISHOP & D.D. PRENTICE (note 31), p. 293; T. FRANKEL (note 17), p. 812-813.

[37] *See supra* paragraph 14.

But also other factors can cause informational problems. Creating, gathering or distributing information can be a costly exercise. Furthermore, it is possible that the information about the performance of an agent does not become known because nobody has an incentive to produce and/or distribute it. This could for instance be the case if all agents have in more or less degree the same bad characteristics.[38] In that case, no agent has an interest in drawing the principals' attention to this "problem": although disclosure might increase the market share of the disclosing agent by showing him to be "less bad" than the others, this gain could be more than compensated by the reduction in the overall size of the market as a result of principals becoming aware of a risk.[39] Concerns about market effects are an important factor in the financial markets, where public confidence in the reliability of financial institutions is essential and loss of confidence in one institution can easily spill over to other institutions and the market as a whole. Also, a free rider problem can limit information production: it is very difficult to appropriate the benefits resulting from this kind of information to the one who produced it, as everybody can use the information once it is produced. As a result, nobody will be prepared to bear the cost to produce the information. This is one of the main reasons why the market tends to produce insufficient information.[40] And last but not least, the relationship between the principal and the agent might be what is sometimes referred to as a "once-and-for-all" contract, a deal once reached or relationship at one time established and subsequently not changed or replaced. This factual characteristic renders the agent to some extent immune from competitive pressures.[41]

17. The result is that principals typically have general knowledge about the fact that some agents might be disloyal, but they do not know in advance whether their agent will act loyally or disloyally.[42] And this creates another type of asymmetric information: as opposed to the principal, the agent typically does know whether he is going to act loyally, and thus possesses *hidden information* at the moment of transacting. In these circumstances, *ex post* knowledge about transactions with unreliable agents only

---

[38] *Cf.* I. WALTER, "Conflicts of Interest and Market Discipline", in C. BORIO, W.C. HUNTER, G.G. KAUFMAN & K. TSATSARONIS (ed.), *Market Discipline across Countries and Industries*, Cambridge, Mass.: The MIT Press, 2004, 175-186, p. 185: "Market discipline that helps avoid exploitation of such conflicts may be weakened if most of the competition is coming from a monoculture of similarly-structured firms which face precisely the same issues"; *see also* M. KNIGHT, "Three Observations on Market Discipline", in the same C. BORIO, W.C. HUNTER, G.G. KAUFMAN & K. TSATSARONIS (ed.), *Op.Cit.*, 11-15, p. 12: "Experience indicates that markets are at their best when identifying a risky institution in an otherwise healthy financial system – the black sheep in the flock, as it were."

[39] *Cf.* R. POSNER (note 30), p. 349, citing the example of tar and nicotine content of cigarettes: even producers of cigarettes with low tar or nicotine content had no interest in voluntarily disclosing this to consumers not aware of the health problems of smoking. *See also infra* footnote 43 and accompanying text.

[40] For instance, even large non controlling shareholders might not want to invest in costly monitoring of corporate management, as the gains of this investment would per se have to be shared with other free riding investors. *See* R. COOTER & B.J. FREEDMAN (note 10), p. 1049; K.B. DAVIS, Jr. (note 17), p. 6; S. LEVMORE, "Monitors and Freeriders in Commercial and Corporate Settings", *Yale Law Journal* 92 (1982) 49-83.

[41] *Cf.* W. BISHOP & D.D. PRENTICE (note 31), p. 293; T. FRANKEL (note 17), p. 815.

[42] This problem is more systemic than one might think at first glance. It is not only the consequence of the fact that the principals cannot in advance know what kind of agent they are dealing with, it is aggravated by the fact that the problem is not a *bias* in the judgment of certain agents, but a *tendency towards a bias* in their judgment, which is not easy to counteract by *ex ante* measures. *See* M. DAVIS (note 5), p. 12.

influence the way the principals perceive the total market for agents *ex ante*: principals will adjust by lowering their global expectations, as they cannot distinguish good agents from bad ones in advance. Through this mechanism, transactions with unreliable agents have external effects on loyal agents: even though they fully perform their duties, principals are not prepared to pay them full value because they want to cover themselves for the perceived risk that the agent would turn out to be disloyal. As a result, the market might suffer from so-called *adverse selection*: prices fall and loyal agents are priced out of the market when being honest is more costly to agents than being dishonest.[43]

If, for instance, disloyal agents confronted with conflicts of interest can remain profitable with lower fees than loyal agents with the same type of conflicts because of the gains the disloyal agents realize from secretly, deliberately or unconsciously pursuing other interests than the interests of the principal, it will be unlikely that the market mechanism alone would solve this problem. Even though principals might prefer agents without conflicts of interest and would even be willing to pay extra for them, and even though some loyal agents are prepared to ignore other potential conflicting interests, the market might end up offering too few or in extreme cases even not any loyal agents if principals cannot reliably recognize such agents.[44]

18. In short, when agents and principals have conflicting interests and the agent has private information about his actions during the performance of the deal (*hidden action*) or about his loyalty at the time of transacting (*hidden information*), the result predicted by classic economic theory is not correct: the first-best allocation of resources – the allocation that would be achieved in a world where all information is common knowledge and which is assumed to be efficient – will not automatically be realized by the market. This means that due to informational inadequacies, the market is not a sufficient mechanism to manage all conflicts of interest. Because of the informational difficulties the principal faces, the agency relationship involves an *agency problem* when the principal and agent have conflicting objectives. The problem is that the strategic behavior of privately informed agents creates *agency costs*:[45] the difference

---

[43] This is also the modified reappearance of Gresham's law according to which "bad" cars tend to drive out the good in the market for second hand automobiles, discussed in the famous article by G.A. AKERLOF, "The Market for "Lemons": Quality Uncertainty and the Market Mechanism", *The Quarterly Journal of Economics* 84 (1970) 488-500.

[44] The condition that principals cannot reliably recognize disloyal agents in advance is crucial for the so-called lemons problem to appear. The fact that reputation is such an important asset in certain professions is often invoked to rebut when the lemons analysis is proposed as a justification for legal intervention in the market. *See e.g.* C. SHAPIRO, "Investment, Moral Hazard, and Licensing", *Review of Economic Studies* 53 (1986) 843, 843: "the lemons assumption that consumers have no seller-specific information seems inappropriate in the professional context, where reputations are so important." It is crucial, we think, to see that this reputation based argument might be relevant when the question is about agency problems relating to competence and general honesty of the professional or service provider about which reputations actually develop, but is a lot less convincing when the agency problems stem from the requirement to completely exclude self-interest as a force directing behavior in cases involving legal conflicts of interest (*see supra* paragraphs 7-10). Given the extreme difficulties to monitor such behavior and to recognize it afterwards, reputational effects might be too limited to be relevant in practice. To put it concretely: we do not think certain financial institutions have a significantly worse or better reputation as to conflicts of interest; we do think that all multifunctional financial institutions might have a problem suffering from the general distrust of the public in all of them after certain scandals became generally known.

[45] *See* J.-J. LAFFONT & D. MARTIMORT (note 33), p. 3.

between the level of aggregate utility created by the first-best allocation of resources and the suboptimal allocation resulting from the market equilibrium that is actually reached.[46]

III. Conflicts of Interest in Asset Management

A. The Inevitability of Conflicts of Interest in Institutional Asset Management

19. A financial institution that offers asset management to individual clients or that manages the portfolios of collective investment schemes essentially offers its clients its knowledge and skill to make and execute investment decisions. These investment decisions are supposed to be inspired exclusively by the investment interests of the client. This promised, bargained for, and therefore legitimately expected, loyalty creates a potential for conflicts of interest.

20. Such conflicts could theoretically be eliminated by changing the substance of the service the financial institution renders the investor. Instead of his best efforts and full loyalty, the financial firm could promise the investor to deliver a specified investment outcome. In the common typology of incentive contracts, this would be characterized as a pure rental contract, in which the agent pays the principal a fixed sum in return for receiving all output realized by his own efforts.[47] Applied to the financial investment sector, such deals of course exist, like in the case of savings accounts, bond financing and some types of life insurance, where the financial institution gets the use of the principal's funds in exchange for a fixed payment.[48] Such a contract contains incentives for the agent to pursue the socially optimal result, because he is fully self interested in doing so, and therefore no conflicts of interest between the principal and the agent arise.

But when the outcome of the agent's actions not only depends on his efforts but is also influenced by external factors, such a contract burdens the agent with all the risk. In situations where the principal is less risk averse than the agent, such a contract would therefore not be optimal: the agent would only be prepared to pay the principal a lower fixed sum – because he wants to be compensated for bearing the full risk – while the principal would be prepared to bear this risk for less.[49] So, even though such transactions exist, they cannot take the place of the service of asset management, which precisely is used in cases where the essence of the deal is that the investor wants to bear more of the risk in return for a higher yield.

---

[46] Agency costs thus include the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests, plus the residual loss incurred because the cost of full enforcement of contracts exceeds the benefits. *See* M.J. JENSEN & W.H. MECKLING, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", *J. Financial Econ.* 3 (1976) 305, p. 308.

[47] For a description of this common typology of incentive contracts, the pure rental contract and its economic characteristics, *see* H.R. VARIAN (note 28), Section 36.7, p. 679 *et seq*.

[48] *See* W. BISHOP & D.D. PRENTICE (note 31), p. 291.

[49] R. COOTER & B.J. FREEDMAN (note 10), p. 1046-1049 and 1067; K.B. DAVIS, Jr. (note 17), p. 6 and 17-18.

21. A second way theoretically to avoid the conflicts of interest would be to specify what decisions the agent should take or to create strict parameters for his decision making, in effect reducing his margin of discretion. Here, the risk caused by the effect of external factors on the outcome of the agent's actions would lie with the principal, but the actions of the agent would be constrained. But in asset management, the investor cannot completely specify in advance what the manager has to do and when, because the services of the financial institution are used precisely to substitute the professional opinions and insights of the asset manager for the opinions of the less knowledgeable, skilled and/or experienced principal or because the principal thinks it to be more efficient not to spend his own scarce time on these matters or wants to take advantage of the economies of scale the agent can realize.[50] Also, at the time of conclusion of the deal, there is insecurity as to the prevailing circumstances at the time the asset manager will have to act, and for investment decisions to be optimal, they have to be adjusted to take into account these circumstances.[51]

In recent practice, however, there is a clear tendency to restrict the freedom of portfolio managers by specifying investment styles the portfolio has to follow and benchmarks for the portfolio's performance.[52] Such mechanisms can be seen as an attempt to alleviate the agency problems in asset management. But while it is possible to limit the freedom of the portfolio manager to some extent, it remains intrinsically inconsistent with the concept of asset management to completely specify the actions of the agent in advance. The financial service of asset management cannot effectively benefit the investor without the portfolio manager enjoying some margin of discretion.[53]

22. Consequentially, an asset manager will *necessarily* be confronted with conflicts of interest. However, the severity of this problem depends on the types of interests the asset manager has that potentially could come into conflict with the customers' interests.

B. Possible Conflicts of Interest for Portfolio Managers

23. The following review will show that asset managers have a number of significant interests – albeit in some cases only through the interests of their other clients – that will be affected by the investment decisions they take for the account of their clients. The following discussion gives some illustrative examples of possible conflicts, without attempting to be exhaustive.[54]

---

[50] *Cf.* W. BISHOP & D.D. PRENTICE (note 31), p. 289; K.B. DAVIS, Jr. (note 17), p. 6 and 17-18; R. COOTER & B.J. FREEDMAN (note 10), p. 1046-1049; T. FRANKEL (note 14), p. 128.

[51] K.B. DAVIS, Jr. (note 17), p. 6 and 17-18; R. COOTER & B.J. FREEDMAN (note 10), p. 1046-1049.

[52] *See* BANK FOR INTERNATIONAL SETTLEMENTS (note 22), p. 19-20.

[53] *Cf.* T. FRANKEL (note 17), p. 809.

[54] For examples of conflicts of interest, including some given here, *see also* G. MCCORMACK, "Conflicts of Interest, Chinese Walls and Investment Management", *International and Comparative Corporate Law Journal* 1 (1999) 5,

1. Conflicts Because the Manager Has Several Clients

24. Conflicts can arise between the interests of different clients of an asset manager because opportunities are limited. This type of conflict may be an unavoidable cost, accompanying the economies of scale created by professionalizing asset management.

The total amount of effort the asset manager can spend is limited and might fall short of the cumulative optimal effort applied to managing all the customers' portfolios, so that principals in effect compete over the agent's time and effort.[55] If conditions are such that not all individual customers are equally able to verify the efforts the manager effectively has applied to their portfolio or not all customers are as active, the asset manager has an incentive to spend proportionally more effort on the informed or critical customers than on the others,[56] and thus in effect overcharging the vulnerable customers for the services they actually receive.[57] Differentiating the fees or other forms of compensation charged to professional versus retail clients based on criteria not linked to the actual costs for the manager, but because retail clients are less able to employ the competition between different asset managers to their advantage, is another example.

Taken to the extreme, even if the asset manager has limited resources to spend on all its customers or an opportunity to invest is too limited to be able to let all customers participate to the extent they would prefer and the asset manager treats all its customers equally by, for instance, letting them all share proportionally in the opportunity, each individual customer could theoretically complain that the duty of loyalty the manager

---

p. 8-9; N.S. POSER, "Chinese Wall or Emperor's New Clothes?", *The Company Lawyer* 9 (1988) 119-123, 159-168 and 203-209, p. 121 (1988), which also appeared in *Mich. Y.B. Int'l Legal Stud.* 9 (1988) 91 and in *Rev. Sec. & Commodities Reg.* 21 (1988) 207; H. MCVEA, *Financial Conglomerates and the Chinese Wall. Regulating Conflicts of Interest*, Oxford: Clarendon Press, 1993, p. 33-35. For a recent taxonomy of conflicts of interest financial services firms are confronted with, *see* I. WALTER (note 38), p. 176-181.

[55] *Cf.* for a discussion of such problems for real estate agents, S. LEVMORE, "Commissions and Conflicts in Agency Arrangements: Lawyers, Real Estate Brokers, Underwriters, and Other Agents' Rewards", *Journal of Law and Economics* 36 (1993) 503-539, suggesting that uniform flat commissions, commonly used in the real estate markets, are a method to mitigate this problem of conflicts of interest among principals.

[56] *Cf.* K.J. HOPT, "Trusteeship and Conflicts of Interest in Corporate, Banking, and Agency Law: Toward Common Legal Principles for Intermediaries in the Modern Service-Oriented Society", in G. FERRARINI, K.J. HOPT, J. WINTER & E. WYMEERSCH (ed.), *Reforming Company and Takeover Law in Europe*, Oxford: Oxford University Press, 2004, 51-88, p. 53 ("Examples are the attribution of newly issued, oversubscribed securities to a favourite large client, a practice that unfortunately was common in the late German New Market.") and p. 61; *see also* I. WALTER (note 38), p. 178 (about spinning); R.A. SCHOTLAND, "Introduction", in *Abuse on Wall Street. Conflicts of Interest in the Securities Market*, Westport-Connecticut – London: 20th Century Fund Report, Quorum Books, 1980, 3-22, p. 11-12. For a practical example of a management company allocating executed orders among several collective investment schemes it managed depending on the subsequent price movements on the market, *see Conflicts of Interest of CIS Operators*, Report of the Technical Committee of the International Organization of Securities Commissions, s.l., IOSCO, 2000, p. 7, available at the web site of IOSCO at <www.iosco.org>; for an example of spinning, *see* G. MORGENSON, "Lawsuit Says Salomon Gave Special Deals to Rich Clients", *New York Times*, 18 July 2002, p. A1 (about a lawsuit claiming that Salomon favored executives of corporate clients in allotting securities, in the hope of attracting or keeping their corporate business); the allegations that James B. Blair, an experienced futures trader and personal friend of Hillary Rodham Clinton, tried to tempt her into commodity trades by shifting other orders to her account after their profit became known, if true, would have been another example. *See* "Hillary Clinton Futures Trades Detailed", *The Washington Post*, 27 May, 1994, p. A01.

[57] For this risk to exist, it is critical that those individual customers either cannot verify whether the asset manager has delivered the appropriate amount of effort or not and/or – for whatever reason – cannot easily change asset manager, because if this were the case, the market would ensure that the customers the asset manager pays less effort on, are charged lower fees.

owes to it has not been honored completely because of the fact that the asset manager has taken the interests of other customers into account.

25. Conflicts between the interests of clients can also result because specific transactions for the account of one or more clients can have repercussions for other clients. Examples are the situation where the value of financial instruments in the portfolio of one client can be influenced by transactions in those instruments for the account of other customers, where the asset manager organizes transactions between the portfolios of two of its customers, or where the knowledge that certain transactions have been decided for one portfolio opens opportunities for so-called front running for the account of other portfolios.[58]

2. Conflicts Because the Manager Also Offers Other Services

26. Conflicts can also exist between the interests of the clients and the interests of a financial institution that also offers other financial services to the same clients. In general, one can intuitively see that the more different services an institution provides, the more it will be confronted with conflicts of interest.[59] The recent expansion of the range of activities of financial institutions offering asset management services has therefore increased the potential for such conflicts of interest.[60]

---

[58] I. WALTER (note 38), p. 177-178; *see also* K. KELLY & S. CRAIG, "NYSE Probe Reaches 5 of 7 Specialist Firms", *The Wall Street Journal*, 18 April 2003, leading to SEC orders against these firms, *see* Releases Nos. 34-49498 to 34-49502 of 30 March 2004, available at the web site of the SEC at <www.sec.gov/litigation/admin.shtml>. According to Article 1(1), Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation (Market Abuse), *Official Journal*, L 96, 21 April 2003, p. 16 (hereinafter referred to as the "MAD"), information "conveyed by a client and related to the client's pending orders" can be inside information for "persons charged with the execution of orders concerning financial instruments"; front running by these persons, therefore, would violate the prohibition of trading using inside information foreseen in Article 2(1), MAD. Information about a person's own pending orders, however, correctly is not qualified as inside information under MAD (in a manner of speaking, one is allowed to front run one's own transactions). MAD does not specify how the information asset managers have about pending orders for the account of their clients should be treated. To be consistent, such information should also be considered as inside information for the asset manager concerned, but as this person is not charged with the *execution* of orders and as this information was not *conveyed by a client* and is not related to the *client's pending orders*, it likely is not covered by the text of the Directive.

[59] *See International Conduct of Business Principles*, A Report of the Technical Committee of the International Organization of Securities Commissions, s.l., IOSCO, 1990, Part One, nr. 9. *see also* I. WALTER (note 38), p. 181-182; N.S. POSER (note 54), p. 119-120; A. CROCKETT, T. HARRIS, F.S. MISHKIN & E.N. WHITE, *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?*, Geneva Reports on the World Economy 5, Geneva: International Center for Monetary and Banking Studies (ICMB) & London; Centre for Economic Policy Research (CEPR), 2003, p. 5: "Conflicts of interest stand out most sharply […] when an institution provides multiple financial services, thereby creating an opportunity for exploiting the synergies or economies of scope by inappropriately diverting some of their benefits."

[60] *See* Recital 29 in the preamble of the MiFID; *see also* the Explanatory Memorandum accompanying the Proposal for a Directive of the European Parliament and of the Council on Investment Services and Regulated Markets, and Amending Council Directives 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC, COM(2002) 625 final, *Official Journal*, C 71, 25 March 2003, 62, at p. 82; F. BUISSON, "La Directive sur les Marchés d'Instruments Financiers: Quels Enjeux pour la Protection des Investisseurs et le Maintien de l'Intégrité du Marché?", *Euredia – European Banking & Financial Law Journal – Revue européenne de Droit bancaire & financier* (2004/2) 237, p. 245-246.

27. Typical examples would include the firm that also offers order execution services and therefore has an incentive to execute all transactions for the account of its clients itself even though alternatives might be better for the investor, or has an incentive to choose transactions it can execute itself over alternative transactions that would require other intermediaries.[61] The same, of course, is possible when the financial institution is a market maker in certain financial instruments,[62] or when the financial institution also internalizes client orders.[63] Deciding to invest for the account of an individually managed portfolio in collective investment schemes sponsored or managed by the same financial group is another example or, to complicate matters more, deciding to invest for the account of one collective portfolio in another collective investment scheme managed or sponsored by the same asset manager.[64] Other cases are the financial institution that also produces investment research and has an incentive not to use other research sources, and the financial institution that also offers asset depository services and therefore has an incentive not to use other depositories. A recent problematic example is the

---

[61] Analogous problems can occur when the asset manager has an arrangement with a certain intermediary under which it receives kickback payments. For a practical example, *see* the IOSCO Report *Conflicts of Interest of CIS Operators* (note 56), p. 6. For a discussion of conflicts of interest relating to the compensation of financial intermediaries, *see* J.-B. ZUFFEREY, "Conflicts of Interest with Respect to the Remuneration of Financial Intermediaries. Some Swiss and Comparative Aspects", in L. THÉVENOZ (ed.), *Aspects Juridiques de la Gestion de Fortune – Legal Aspects of Investment Management*, Brussels: Bruylant and Berne: Stämpfli, 1999, p. 223-238.

[62] For an example of collective investment schemes investing in real estate purchased from a related real estate company, *see* the IOSCO Report *Conflicts of Interest of CIS Operators* (note 56), p. 5.

[63] This type of conflict was on the mind of the European legislator when it generally allowed internalization of orders in the MiFID. *See* COM(2002) 625 final (note 60), p. 18: "The debate surrounding "internalisation" has thrown into sharper relief the already commonplace conflict of interest that arises when investment firms cumulate the functions of broker and dealer. Execution of client orders against the firms' proprietary positions begs the question of whether investors can be confident that their interests are paramount when the broker-dealer acts on their behalf. These concerns are exacerbated where an investment firm implements systems and procedures to maximise the number of client orders executed against proprietary positions or other client orders." About internalization of orders, *see* for instance D. ROLLAND & B. BREHIER, "L'internalisation des ordres", *Banque & Droit* 102 (July-August 2005) 17-21; A. CAPARROS, "Understanding the New Regime for Internalisation of Order Flow in Europe", *Euredia – European Banking & Financial Law Journal – Revue européenne de Droit bancaire & financier* (2004/2) 269-283; J.-J. DAIGRE, "La libéralisation de l'exécution des ordres en interne au risqué de la fragmentation des marchés", *Euredia – European Banking & Financial Law Journal – Revue européenne de Droit bancaire & financier* (2004/2) 285-299.

[64] A comparable practice exists when financial institutions systematically promote so-called "house products" to retail customers that are under the impression that they are receiving impartial investment advice. The recent trend towards so-called "open architecture" does not eliminate this practice, as even then financial institutions usually only promote products of suppliers with whom they have distribution agreements. *See* I. WALTER (note 38), p. 178-179; for the example of Morgan Stanley being fined for organizing sales contests to sell in-house products, *see* NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., *NASD Monthly Disciplinary Actions*, October 2003, p. D18, available at the web site of the NASD at <www.nasd.com>, and A. MICHAELS & D. WELLS, "Morgan Stanley Fined over Mutual Funds", *Financial Times*, 17 September 2003, 32; *see* for another example A. LUCCHETTI, "Schwab Gives Own Funds Top Billing – Brokerage Firm's 'Short List' Includes 4 of its Portfolios, Raising Concerns of Conflict", *Wall Street Journal*, 3 September 2002; for a case where a broker was fined because it had failed to disclose to its customers that it received huge incentives from a financial institution to promote its mutual funds through so-called neutral advice to its customers, *see* U.S. SECURITIES AND EXCHANGE COMMISSION, Administrative Proceeding Release No. 33-8520 of 22 December 2004 in the Matter of Edward D. Jones & Co., L.P., available at the web site of the SEC at <www.sec.gov/litigation/admin/33-8520.htm>.

financial institution that provides credit or loans to investors, the proceeds of which can be used to fund the investment transactions.[65]

28. In all of these examples, the financial institution has an incentive to use more of these other services it offers than would be optimal for the client. The most known example is the "churning" of the portfolio, where transaction frequency is higher than would be in the best interests of the client in order to generate transaction fees for the financial institution,[66] but in much the same way a financial institution could recover too much of its investment research costs from its asset management clients by demanding more such research than optimal.

29. The interests of the clients using the different services of the financial institution can also conflict directly with each other. Such conflicts will occur when the financial institution has a duty of loyalty to both clients. The most typical example in this category is the conflict between the interests of the clients whose portfolio is managed and the interests of the issuer of financial instruments the financial institution has promised to place in the market.[67] The duty the firm has to further the interest of the issuer in trying to successfully complete the offering, creates an incentive to "dump" the so-called "*queues d'émissions*" in portfolios it manages.[68]

30. Conflicts can also arise between the interests of the asset management clients and the firm itself because it also has clients using other services. Even when the financial institution offers other services that do not imply a duty of loyalty towards those clients, the institution itself has an interest to keep these customers happy so that they do not

---

[65] *See* I. WALTER (note 38), p. 178; *cf.* the recent disputes between Dexia Bank Nederland and several groups representing claimants and small investors which ended with a settlement agreement reached with the help of the late W.F. Duisenberg, former President of the European Central Bank. For more information about the settlement reached, *see* the web site of Dexia at <www.dexialease.nl>; for more information about the disputes and the share-leasing practice that caused them, *see* "Wim Duisenberg, médiateur entre Dexia et les épargnants néerlandais", *Le Monde*, 16 February 2005, p. 18; "Duisenberg to Mediate in Dexia Dispute", *Financial Times*, 11 February 2005; *see* for a similar problem G. MORGENSON, "Salomon Faces Complaints Over Options at WorldCom", *New York Times*, 24 April 2001, p. C1; for the disciplinary decision in this matter, *see* NEW YORK STOCK EXCHANGE, Exchange Hearing Panel Decision 03-182, 1 October 2003, Citigroup Global Markets Inc. formerly known as Salomon Smith Barney Inc., available at <www.nyse.com/pdfs/03-182-183.pdf>.

[66] *See* M. MAYER, "Broker-Dealer Firms", in *Abuse on Wall Street. Conflicts of Interest in the Securities Market*, Westport-Connecticut – London: 20th Century Fund Report, Quorum Books, 1980, 433-497, p. 436; N.S. POSER (note 54), p. 121; I. WALTER (note 38), p. 179; *see also* U.S. Securities and Exchange Commission Investor Alert, "Analyzing Analyst Recommendations", available on the SEC's site <www.sec.gov/investor/pubs_alpha.shtml>; L.S. UNGER (Acting Chairman of the US Securities and Exchange Commission), "Written Statement Concerning Conflicts of Interest faced by Brokerage Firms and their Research Analysts before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services", US House of Representatives, Hearing "Analyzing the Analysts", Tuesday, July 31, 2001, p. 3, available in "Printed Hearings from 107th Congress" on the site of the Committee, <http://financialservices.house.gov/hearings.asp>.

[67] *See* K.J. HOPT (note 56), p. 61; G. MCCORMACK (note 54), p. 8-9; R. CRANSTON, *Principles of Banking Law*, Oxford: Clarendon Press, 1997, p. 23; N.S. POSER (note 54), p. 121; SEC Investor Alert, "Analyzing Analyst Recommendations" (note 66). For an example of an operator of a collective investment scheme investing managed funds in securities underwritten by an affiliated party to help the issuer reach minimum subscription standards, *see* the IOSCO Report *Conflicts of Interest of CIS Operators* (note 56), p. 5.

[68] *See* I. WALTER (note 38), p. 179; this practice has been alleged to have taken place in Belgium. *See* "Rapport de la Commission des Finances", *Documents du Senat*, 1994-95, nr. 1352/2, p. 89.

walk away, or has an interest to tempt potential new customers for these services.[69] For example, the asset management unit of a multifunctional financial institution could be tempted to use the voting rights attached to the portfolio's shares in a company that is a client of the investment banking arm of the conglomerate in a manner preferred by the management of that client company that might not be in the best interests of the owner of the portfolio.[70] The potential to control a significant amount of transactions for the account of clients might also be a powerful argument to attract investment banking business, which would give the financial institution an incentive to use its asset management mandate to further the marketing interests of its investment banking division instead of to maximize the value of the portfolio for the client.[71]

3. Conflicts Because the Manager Has a Stake in the Consequences of Transactions

31. When the financial institution also trades for its own account or has a personal investment portfolio, it can have an interest in the consequences of transactions for the account of clients.[72] A typical example would be transactions that can influence the market price of instruments the institution is interested in for some reason.[73] This can lead to abuses, especially in the case of take-overs or buy-outs, where the manager uses his discretion over the managed portfolios to influence the outcome of the transaction or battle by purchasing (or not purchasing, selling or not selling, as the case might be)

---

[69] In general, larger companies do not easily accept their investment or commercial banker not to show an interest in the securities they issue. *See* L.S. UNGER (note 66), p. 3 and 13; S.E.C. Investor Alert, "Analyzing Analyst Recommendations" (note 66).

[70] *See* I. WALTER (note 38), p. 177 and in particular footnote 9, p. 22-23, giving the example of the 2001-2002 effort by Hewlett-Packard Co. to acquire Compaq Computer Corp., using its power over Deutsche Bank and Northern Trust Co. as one of their important corporate finance clients to "influence" the vote of the asset management arm of these financial institutions. The asset management arm of Deutsche Bank was fined by the SEC for not disclosing its conflict of interest in the matter. *See* U.S. SECURITIES AND EXCHANGE COMMISSION, Administrative Proceedings Release No. IA-2160, In the matter of Deutsche Asset Management, Inc., 19 August 2003, available at the web site of the SEC at <www.sec.gov/divisions/enforce/enforceactions.shtml>.

[71] We recently have witnessed examples of such behavior in the investment research sector. *See* in general "Analyzing the Analysts", Hearings before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, U.S. House of Representatives, 107th Congress, First Session, 14 June & 31 July 2001, Serial No. 107–25, available in the "Printed Hearings from 107th Congress" on the web site of the Committee, <http://financialservices.house.gov/hearings.asp>; *Report on Analyst Conflicts of Interest*, A Report of the Technical Committee of the International Organization of Securities Commissions, s.l., IOSCO, September 2003, available on the web site of IOSCO at <www.iosco.org>; for Europe, *see* for instance the work product of the Forum Group on Financial Analysts, appointed by the European Commission, *see* Press Release IP/02/1763 of 28 November 2002, available on the web site of the Commission, <http://europa.eu.int/rapid>, and *Financial Analysts: Best Practices in an Integrated European Financial Market*, Recommendations from the Forum Group to the European Commission Services, 4 September 2003, available on the web site of the Commission, <http://europa.eu.int/comm/internal_market/securities/analysts/index_en.htm>.

[72] For an example involving an asset manager trading for the account of clients and for his own account and making late allocations of these trades, *see* the IOSCO Report *Conflicts of Interest of CIS Operators* (note 56), p. 10.

[73] For a general discussion, *see* S.E.C. Investor Alert, "Analyzing Analyst Recommendations" (note 66). A known practice are the so-called booster shots, where a financial institution just before the lock-up period – that is the period following an IPO during which the financial institution and/or its employees cannot sell the pre-IPO shares they own – supports the market price of the shares to enable it to liquidate its own position at a (higher) profit. *See also* L.S. UNGER (note 66), P. 3, 6, 8 and 12.

shares for the account of clients.[74] Another case is the manager that channels transactions for the account of its customers into instruments issued by related issuers, or that uses the transactions for the portfolios it manages to influence the market price of instruments it has issued itself or that are issued by a related party.[75] Also, a credit institution might have an interest in supporting a potentially troubled debtor by channeling investment into securities issued by this debtor, thus trying to mitigate its own credit risk and in effect shifting it to the managed portfolios.[76]

C. Resulting Agency Costs for Asset Management

32. The previous section has demonstrated some of the conflicts of interest confronting asset managers. The question then becomes whether these conflicts create agency problems that will not be tackled by normal market forces based on standard legal rules and remedies, in other words, whether specific rules are required to redress the agency costs created by these conflicts of interest. Three types of reasons potentially justify intervention.

1. Adverse Effects to the Interests of the (Small?) Investor

33. The initial concern that one often hears voiced is that conflicts of interest hurt the interests of the investor directly because some asset managers do not effectively deliver the quality of service for which the customer has paid.[77] The increasing attention that lately has been paid to the problem of conflicts of interest is partially explained by recent financial scandals breaking in a period of already relatively modest returns on investments, causing many investors to lose money contrary to their expectations.[78]

---

[74] For examples, *see* the IOSCO Report *Conflicts of Interest of CIS Operators* (note 56), p. 7. *See also* K.J. HOPT (note 56), p. 62.

[75] For an example of an asset manager buying and selling a number of bonds issued by an affiliated company from and to this company, and even an example of a collective investment scheme buying and selling from and to the operator unlisted securities issued by that operator as part of its share capital, *see* the IOSCO Report *Conflicts of Interest of CIS Operators* (note 56), p. 5.

[76] L. ENRIQUES (note 3), p. 17, gives the recent examples of the behavior of Italian banks in the Cirio and Parmalat cases. *See also* J.A.C. SANTOS, “Commercial Banks in the Securities Business: A Review”, Basle: BIS Monetary and Economic Department, Working Papers No. 56, 1998, p. 10; I. WALTER (note 38), p. 181. Raising the level of creditworthiness of credit clients is an obvious interest of credit institutions. *See also* R. CRANSTON (note 67), p. 23; N.S. POSER (note 54), p. 121.

[77] For instance, Investars.com calculated *post factum* that from January 1997 till May 2001 only 4 of the 19 largest U.S. brokerage firms gave investment advice that would have realized a surplus value and the highest return that would have resulted from following the advice of any single one of these firms would only have been 7.6%, even when during that same period the S&P 500 increased with 58% and the NASDAQ more than doubled. *See* D.W. TICE (Portfolio Manager, Prudent Bear Fund, and publisher of the institutional research service “Behind the Numbers”), “Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street”, Testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services, US House of Representatives, Hearing Entitled “Analyzing the Analysts”, Tuesday, June 14, 2001, p. 16 *et seq*., available in the “Printed Hearings from 107th Congress” on the web site of the Committee, <http://financialservices.house.gov/hearings.asp>. For other and more recent numbers, *see* <www.investars.com>.

[78] *See* N. MOLONEY, “Time to Take Stock on the Markets: The Financial Services Action Plan Concludes as the Company Law Action Plan Rolls Out”, *International and Comparative Law Quarterly* 53 (2004) 999, p. 1003; A.

Designing specific measures to regulate conflicts of interest is therefore often perceived as a necessary part of investor protection.[79]

34. However, this rationale assumes that the investor is not able to protect his own interests by negotiating *ex ante* compensation, such as the payment of a lower asset management fee to compensate for the risk posed by the conflicts of interest,[80] by negotiating specific contractual duties and remedies for potential abuses of conflicts of interest by the financial institution,[81] or simply by using less of these financial services and in that way discounting the risk posed by the conflicts of interest.[82] The investor is only harmed to the extent that he pays for more than he actually receives. If the risk that conflicts of interest pose is fully reflected in the market price for asset management services, the interests of the investor do not need any special protection as differentiated from anybody else's interests. In that sense, the potentially self-serving behavior of asset managers is not per se "bad" as long as this is reflected in the price paid for the service by the investor.[83]

CROCKETT, T. HARRIS, F.S. MISHKIN & E.N. WHITE (note 59), p. 1-2; *see also* J.-B. ZUFFEREY, "Regulation of Financial Analysts. A Good Illustration of the Current Trends in Financial Market Law", elsewhere in this book. In general, *see* P. KLURER, "Mainsprings of Financial Services Regulations. Towards a Dynamic Model of Understanding Changes in Legal, Regulatory and Ethical Risks of the Financial Services Industry", in R. WALDBURGER, CH.M. BAER, U. NOBEL & B. BERNET (ed.), *Wirtschaftsrecht zu Beginn des 21. Jahrhunderts*, Festschrift für Peter Nobel zum 60. Geburtstag, Bern: Stämpfli Verlag AG, 2005, 575-582, p. 578.

[79] See *e.g.*. recital 29 of the preamble of the MiFID: "It is [...] necessary to provide for rules to ensure that […] conflicts [of interest] do not adversely affect the interests of […] [the] clients [of investment firms]." *See also* COM(2002) 625 final (note 60), p. 82, discussing the conflict of interest rules as part of the rules on investor protection in the proposed MiFID.

[80] *Cf.* J.A.C. SANTOS (note 76), p. 11: "economic theory suggests that if agents are moderately rational, when they enter into a contracting relationship they will consider the other party's incentives and, as a result, they will not generally be fooled. […] If investors perceive that a bank has been exploiting a certain conflict of interest they can take that into account by applying a 'lemons' discount to the bank's products affected by such conflict." We would add that to the extent the investors can perceive the risk that firms are confronted with conflicts of interest but are not able to distinguish between the firms that would behave loyally and those that would behave disloyally – which seems to be the situation in reality – they will apply a 'lemons' discount to the products of all these firms (*see supra* footnote 43 and accompanying text). If the investors can distinguish between the types of firms, which is the situation Santos seems to be referring to, the adverse selection problem Akerlof (supra note 43) was analyzing simply does not exist; it is therefore better not to call a discount applied to a "bad" type provider that is not applied to a "good" type provider a "lemons discount".

[81] *Cf.* J.R. BOATRIGHT, "Conflict of Interest in Financial Services: A Contractual Risk-Management Analysis", paper presented at the Tenth Annual Meeting Promoting Business Ethics, St. John's University, 2003, The Hastings Center, Garrison, NY, April 10, 2003, available at <http://sba/luc/edu/research/wpapers/040602-B.pdf>; J.R. MACEY, "Fiduciary Duties as Residual Claims. Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective", *Cornell Law Review* 84 (1999) 1266, p. 1268, who both argue that fiduciary duties or more generally conflict of interest rules in so far as they are embodied in law are default rather than mandatory rules, adopted voluntarily, the result of contracting, or in short: the outcome of the normal workings of the market mechanism. *See also* F.H. EASTERBROOK & D.R. FISCHEL, "Contract and Fiduciary Duty", *Journal of Law and Economics* 36 (1993) 425-446.

[82] Compare the way in which investors discount the forecasts and recommendations of financial analysts that are confronted with conflicts of interest, discussed in M. DUBOIS & P. DUMONTIER, "Do Conflicts of Interest Affect Analysts' Forecasts and Recommendations? The Empirical Evidence", elsewhere in this book; *see also* A. CROCKETT, T. HARRIS, F.S. MISHKIN & E.N. WHITE (note 59), p. 75-76, giving several examples where they see the market mechanism discounting the bias created by conflicts of interest in several sectors.

[83] *Cf.* K.B. DAVIS, Jr. (note 17), p. 20.

35. Therefore, from an investor protection perspective, conflicts of interest only warrant special attention if the market mechanism has failed to take them into account.[84] However, for this to be the case, asset managers would have to be able to keep the fact that they are confronted with conflicts of interest a secret, because if enough investors become aware of the problem, the market price for asset management services and/or the demand for such services will be forced down to take into account the anticipated risk. If conflicts of interest are a generally known problem, the market conditions for asset management services will protect the interests of the investor, unless they would systematically underestimate the risk or the consequences of the risk. Also, if the essence of the investor protection issue is a market failure because of missing information, the obvious legal technique to overcome this problem is to impose disclosure, and normally disclosure by itself should suffice.

36. From the point of view of protecting the investor, one could easily jump to the conclusion that these measures should especially focus on the small or unsophisticated investor, who allegedly needs to be protected most.[85] This would avoid the problem that applying uniform standards to situations involving heterogeneous customers generally creates, *i.e.* setting the bar too high for services provided to clients that need and prefer less protection.[86] However, the market is expected to protect all investors alike, unless specific conditions exist to render this untrue. So why would the market mechanism offer less protection against conflicts of interest to retail investors than to professionals, resulting in more need to protect the one than the other type of investor?

37. A first situation in which the market might fall short of protecting the unsophisticated investor can arise when the asset managers can effectively separate the markets of retail and professional investors, so that the prices and conditions on one market segment are not directly influenced by the conditions on the other. Only then will the professional investors' skepticism not lower the price unsophisticated customers have to pay. In those circumstances, it might help to impose extra disclosure requirements for retail investors that are not necessary for professional clients.

38. Another reason why the market might fail to protect the interests of the investor is when this investor is too "loyal" to his asset manager for competitive advantages of

---

[84] *See* K.B. DAVIS, Jr. (note 17), for an analysis and explanation of the differing fiduciary rules applicable to several types of fiduciaries (trustees, corporate managers, partners, etc.) precisely based on the varying market conditions the services they offer are subject to. According to his thesis, fiduciary law interferes more when the market shows shortcomings in protecting the interests of the beneficiary and less when the market seems to function well.

[85] The inequality between investors and financial institutions is sometimes invoked as a reason to apply more strict rules for conflicts of interest in the financial sector. *See* for instance H. MCVEA (note 54), p. 33-35; *Jirna Ltd v. Mister Donut of Canada Ltd*, 13 D.L.R. (3d) 645 (Ont. H.C., 1970), 22 D.L.R. (3d) 639 (Ont. C.A., 1972), 40 D.L.R. (3d) 303 (S.C.C., 1973), referred to by E.J. WEINRIB, "The Fiduciary Obligation", *University of Toronto Law Journal* 25 (1975) 1, p. 6: no special protection against conflicts such as fiduciary duties were imposed among other reasons because no such protection would be warranted in transactions between experienced business people with equal bargaining strength "acting at arm's length".

[86] *Cf.* H.E. LELAND, "Quacks, Lemons, and Licensing: A Theory of Minimum Quality Standards", *Journal of Political Economy* 87 (1978) 1328, p. 1336-1337.

other managers to convince him to change. Here, a clear case can be made for special protection of retail investors. Given their limited knowledge of, insight in, and experience with financial instruments and the workings of the financial markets and in particular the specific risks involved, most retail investors are not capable of taking care of their own investment needs. In reality, such investors have only one rational investment choice and that is to turn to financial institutions to assist them in protecting these interests.[87] Professional investors much more often can take care of their own investment needs, and this provides them with an alternative to using an external professional asset manager. But even when professional investors in reality do use the services of professional portfolio management, they tend to shop around much more than retail investors. In many countries, small investors have the habit of using one bank branch for all their financial needs, and it takes a big disappointment in this relationship for the client to switch. Thus, these financial institutions become partially shielded from competition for the individual services they render to these retail customers.

39. In general, however, the agency problem created by a conflict of interest is not the result of the unequal bargaining position of the parties at the time of transacting, which is the traditional rationale for introducing measures to protect consumers against the unconscionability problem. Instead, this agency problem is created by a vulnerability of the investor for disloyal behavior imbedded in the essential characteristics of the asset management relationship *resulting from* the agreement.[88] This is caused by the fact that the power the asset manager has over the interests of the investor intrinsically is, and inherently has to be, broader than necessary for him to be able to do the job: "the purpose for which the [asset manager] is allowed to use his delegated power is narrower than the purposes for which he is capable of using that power".[89] This means that the essential breeding ground for conflicts is in principle the same independent of the type of investor or his level of sophistication. As a general matter, therefore, intervention should not be justified on the basis of the need to protect small investors, as, while retail investors do have special problems, the basic problem posed by conflicts of interest is in essence the same for small investors and sophisticated, informed investors capable of bargaining or negotiating for their own interests.

2. Undermining Capital Market Integrity

40. But there is more. The fact that asset managers might not fully deliver on their promises to investors is not only a problem for these investors' interests but also for the wider economy in general. Conflicts of interest in asset management might jeopardize

---

[87] It is interesting to see that, even though the direct accessibility of financial markets has recently increased, for example through the use of the internet, at the same time the share of household wealth that is managed by financial institutions has recently increased sharply. *See* J. FRANKS, C. MAYER & L. CORREIA DA SILVA, *Asset Management and Investor Protection. An International Analysis*, Oxford: Oxford University Press, 2003, p. 33 *et seq.*; *see also* E.P. DAVIS & B. STEIL, *Institutional Investors*, Cambridge, Mass.: MIT Press, 2001.

[88] E.J. WEINRIB (note 85), p. 6; T. FRANKEL (note 17), p. 810.

[89] T. FRANKEL (note 17), p. 810.

the integrity of the financial markets. These markets perform an important function in our economy, directing available capital to alternative productive purposes or, to look at it the other way around, offering alternative financing techniques for productive projects. To be efficient, capital available from investors should be invested in the instruments that offer these investors the maximum utility given their needs, including their risk preferences and time horizons. If because of their personal interests financial intermediaries such as asset managers divert invested moneys to suboptimal uses, the financial markets fail in their crucial function: the optimal allocation of capital.[90] Bias in this intermediation could lead to overinvestment in certain economic sectors at the cost of underinvestment in other sectors,[91] overinvestment in certain regions resulting in underinvestment elsewhere, or overinvestment in certain types of instruments at the detriment of other types investment vehicles.[92] Judged from this perspective, designing measures in order to minimize these negative effects on the economy as a whole by tackling the conflicts of interest problem in the financial sector is not an issue of investor protection but is rather in the general public interest, including the business interests of companies.[93]

41. But here one can wonder whether the essence of this problem is not akin to the issues involved in vertical integration and restraints in competition policy.[94] Isn't the financial institution that through some link has an interest to steer investors more to certain investments than others comparable to the supermarket that has an interest to

---

[90] *See* R. GLANTZ, "Oral Testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services", US House of Representatives, Hearing Entitled "Analyzing the Analysts", Tuesday, July 31, 2001, p. 5: "That's not only bad for the average investor, it undermines one of the primary reasons for having a stock market – the efficient allocation of investment dollars", available in the "Printed Hearings from 107th Congress" on the web site of the Committee, <http://financialservices.house.gov/hearings.asp>; D.W. TICE (note 77), p. 15 *et seq*.; see *also* H. MCVEA (note 54), p. 30.

[91] Examples were for instance the difficulties companies with more "traditional" business plans encountered to successfully collect capital through new public issues of securities during the so-called dot-com boom of the late nineties.

[92] For instance overinvestment in newly offered financial instruments at the detriment of underinvestment in the secondary markets, when financial institutions stand to earn more in IPOs than in intermediation in the secondary market.

[93] *Cf.* K.J. HOPT, "Prävention und Repression von Interessenkonflikten im Aktien-, Bank- und Berufsrecht", in S. KALSS, CHR. NOWOTNY & M. SCHAUER (ed.), *Festschrift Peter Doralt zum 65. Geburtstag*, Wien: Manzsche Verlags- und Universitätsbuchhandlung, 2004, 213-234, p. 214, stating that often specific regulation of conflicts of interest is intended "eine bestimmte Interessenwahrungsfunktion zu sichern oder einen ohne saubere Interessenwahrung nicht ordentlich funktionierenden Markt zu fördern." *Cf. also* the realization that, given the importance of delegated portfolio management relationships in modern day financial markets, the study of agency aspects of delegated portfolio management, in particular the study of the proper incentive contracts, performance measuring systems, etc., should focus on the general equilibrium implications of these mechanisms. *See* L. STRACCA, "Delegated Portfolio Management. A Survey of the Theoretical Literature", ECB Working Paper No. 520, September 2005, p. 32, available at the web site of the European Central Bank at <www.ecb.int> and in the Social Sciences Research Network electronic library, <www.ssrn.com/abstract=781088>, to be published in the *Journal of Economic Surveys*.

[94] One could argue that this problem is in essence one of a diminishing distinction or demarcation between markets on the one hand and intermediaries or agents active on markets on the other, as more allocation decisions are taken within a financial institution instead of being the result of a traditional market transaction between financial institutions. *Cf.* K. VUILLEMIN, "Libre propos sur la directive relative aux marchés d'instruments financiers 2004/39/CE", *Bulletin Joly Bourse*, §119 (September-October 2004) 579, p. 580: "La place financière européenne est devenue complexe, rendant de plus en plus invisible la frontière marchés et intermédiaires."

steer its customers more to the products of one brand than to others, maybe not even offering competing brands, when it has a preferential distribution arrangement with a certain manufacturer? Wouldn't enough competition on the market of asset management between different financial institutions with different vertical links creating conflicts of interest or in other words the splitting of the assets of investors over enough financial institutions with a limited market share avoid this problem?[95]

3. Suboptimal Asset Management Market Efficiency

42. Last but not least, there is a case for tackling the conflicts of interest problem in asset management because of the effect it might have on the confidence of investors in financial institutions in general.[96] In financial markets, where institutions are especially dependent on the public confidence posed in them, this issue has to be taken very seriously.[97]

43. First, an individual financial institution under suspicion of behaving disloyally as an asset manager might suffer by losing customers, and as a result potentially by a loss in the financial firm's market value.[98] If this suspicion is correct, of course, this consequence is desirable and serves as a market mechanism to deter misbehavior. However, when this suspicion is unwarranted, it might be very difficult to almost impossible for the financial institution to convince the public by proving its honesty. Moreover, suspicions of dishonesty can easily spill over from one institution to the other. Therefore, it is in the interests of every individual financial institution that no such suspicions arise because of the behavior of other institutions, and this might require regulatory intervention.[99]

44. Second, as already discussed,[100] the price investors are prepared to pay for asset management services might become depressed as a result of their anticipation of potential abuses of conflicts of interest by some of these managers. As a consequence, the managers that act disloyally when faced with conflicts of interest might increase their market share, as they are better able to remain profitable under these market conditions. This, in turn, will encourage asset managers to abuse conflicts of interest. The

---

[95] *Cf.* BANK FOR INTERNATIONAL SETTLEMENTS (note 22), p. 32-33: "Avoidance of explicit and implicit barriers to market entry: To support market efficiency and liquidity, and to help limit volatility, care should be taken to maintain an environment that encourages market entry by pooled investment vehicles in general and by specialised investment pools seeking to exploit arbitrage opportunities in particular. […] A similar reasoning applies to other parts of the institutional investment industry, particularly if these are characterised by a high degree of concentration and potential conflicts of interest."

[96] *See also* H. MCVEA (note 54), p. 4 and 30.

[97] For a study showing how severe the effects can be of a limited lack of trust of investors in "the system", *see* L. GUISO, P. SAPIENZA & L. ZINGALES, "Trusting the Stock Market", National Bureau of Economic Research (NBER) Working Paper 11648, September 2005, abstract available at <http://nber15.nber.org/papers/w11648>.

[98] *See* I. WALTER (note 38), p. 183-184.

[99] *Cf.* J. CLIJSTERS, "La déontologie bancaire et financière. Le point de vue d'un banquier", in *La déontologie bancaire et financière – The Ethical Standards in Banking & Finance*, Cahiers AEDBF/EVBFR-Belgium, Brussels: Bruylant, 1998, 113-124, p. 116.

[100] *See supra* paragraph 17.

market mechanism might thus render the problem worse instead of solving it because of the phenomenon of adverse selection.[101] In the end, individual investors will be less prepared to use the services of asset managers than would be socially optimal or will receive less honest services than they would desire.[102] Instead, they might choose alternative methods to manage their savings, maybe substituting some direct investment in securities for delegated portfolio management, maybe avoiding investing in securities all together,[103] consequentially realizing a less than optimal return on these savings while at the same time increasing the cost of capital for enterprises.[104] Here, again, it would seem that tackling the problem of conflicts of interest in asset management and in financial institutions in general is a matter of general public interest, not merely an issue of investor protection.

IV. Legal Approaches to Conflicts of Interest in Asset Management

A. Imposing Fiduciary Duties

45. Probably the oldest legal concept specifically developed to deal with conflicts of interest is the so-called fiduciary law, originally developed in equity but nowadays forming a standard part of the law in common law jurisdictions. As opposed to in continental European civil law countries, where no such special system exists, under fiduciary law, not only is a duty of loyalty imposed in certain circumstances where standard law does not, but – and this is the characteristic element which is relevant for the discussion here – this equitable or fiduciary duty of loyalty also differs from a duty of loyalty as it would be imposed by non-fiduciary or standard private law.[105] Without attempting to fully or in depth discuss this very peculiar system of principles, rules and

---

[101] As Akerlof pointed out, "The presence of people in the market who are willing to offer inferior goods tends to drive the market out of existence […]. It is this possibility that represents the major costs of dishonesty – for dishonest dealings tend to drive honest dealings out of the market. […] The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence." G.A. AKERLOF (note 43), p. 495.

[102] *Cf. International Conduct of Business Principles*, A Report of the Technical Committee of the International Organization of Securities Commissions, s.l., IOSCO, 1990, Part One, nr. 7: "Smaller investors, whether they participate directly in the markets, or indirectly through mutual funds or pension funds, continue to be considered vital to the functioning of the markets. Their continued participation depends upon confidence in the integrity of the market and in the firms with which they deal."

[103] *See also* R.A. SCHOTLAND (note 56), p. 12-13.

[104] Recent research has suggested that delegated portfolio management leads to a larger demand for risky assets than if individual investors would invest in these assets directly, so the overall result of a more widespread use of delegated portfolio management might be a lower required equity premium, consistent with the evolution in the markets during the 1990s. *See* S. KAPUR & A.G. TIMMERMANN, "Relative Performance Evaluation Contracts and Asset Market Equilibrium", *Economic Journal* 115 (2005) 1077, p. 1078. One can therefore assume that a decreased recourse to delegated portfolio management will lead to a lower demand for risky assets and/or a higher required equity premium.

[105] It is thus not enough for a duty to require "loyalty" as a normative content for this duty to be "fiduciary" or equitable in nature. There is a clear distinction between a "legal" or "standard private law" duty of loyalty and a "fiduciary" duty of loyalty. Unfortunately, in a lot of continental European legal writing any duty that requires loyalty is called a fiduciary duty, rendering this term rather meaningless.

remedies,[106] a few particularly relevant elements of this legal system should be discussed.

46. The first element deserving our attention is the applicable remedy. To appreciate this, we first have to return to the "standard" – in the sense of "non-fiduciary" – legal relationship between a principal and an agent imposing on the agent an open-ended duty of best efforts or a duty to act with care. In such a relationship, the agency problem is that the agent might shirk his duties, try to spend less effort or care than is required. The standard legal remedy against such a breach of duty, both in tort and contract disputes, is full compensation of the damage incurred by the principal.[107] Judged at the time of acting, the anticipated damages that as a consequence of a breach of duty will have to be paid are almost always larger than the effort the agent anticipates to save by deciding to shirk his duties.[108] In this sense, damages as a remedy for a breach of a duty to act with care have a punitive element when viewed from the perspective of the wrongdoer: he will have to pay more than he stands to gain.[109] In general, therefore, there is no reason to fear that this remedy will not provide an incentive for the debtor to comply. The economic agency problem involved in a duty to act with care will thus in general be effectively addressed by the "normal" or "standard" legal technique of liability for damages caused by one's fault, which is known in both common and civil law systems.[110]

47. When the debtor is under a duty of loyalty, however, the situation becomes essentially different. In that case, the remedy of damages or compensation of the victim alone will per definition not suffice to provide a credible incentive for the debtor to comply. Indeed, such a remedy would only steer the debtor away from a breach when his actions are anticipated to damage the principal more than they are anticipated to benefit him, but not in those situations where he anticipates that he can gain more from breaching the duty than this breach would cost the principal. The remedy of damages, in effect, only provides an incentive for the agent to weigh his own interests against the

---

[106] Fiduciary duties have been referred to as "the law's most exotic species". *See* D.A. DEMOTT (note 10), p. 923.

[107] For a general discussion why in general cases of duties of care damages are a more efficient remedy than disgorgement of profits for the wrongdoer, *see* A.M. POLINSKY & S. SHAVELL, "Should Liability Be Based on the Harm to the Victim or the Gain to the Injurer?", *Journal of Law, Economics & Organization* 10 (1994) 427-437.

[108] If the *ex ante* predicted damage resulting from the behavior of the agent does not exceed the *ex ante* predicted cost of the effort it would have required to act in a way to prevent the damage, the behavior of the agent will most of the time not be negligent and, therefore, will normally not bring about a remedy. This, of course, assumes that the negligence standard applied approaches the so-called Learned Hand Formula, most clearly formulated by Judge LEARNED HAND of the U.S. Court of Appeals for the Second Circuit in *United States v. Carroll Towing Co.*, 159 F.2d 169, p. 173-174 (2d Cir. 1947), which defines negligence as a function of the probability of a harmful event occurring or the magnitude of the risk (P), the extent of the damage that may result or the gravity of the harm (L) and the cost of preventing the occurrence of the harmful event or the burden of prevention (B): according to this formula conduct is negligent if $B < PL$. *See also Restatement (Second) of Torts* §291 (1965); *see* for this concept of negligence in general R.A. POSNER, "A Theory of Negligence", *Journal of Legal Studies* 1 (1972) 29.

[109] R. COOTER & B.J. FREEDMAN (note 10), p. 1059-1060.

[110] It is of course possible that information problems make it prohibitively difficult for the victim to prove the fault of the debtor. However, such problem could effectively be dealt with by shifting the burden of proof, rendering the debtor liable unless he shows that enough effort was used.

interests of the principal when deciding how to act, but does not contain a proper incentive to *exclude* his own interests from that decision process, which is required under a duty of loyalty. Thus, the standard legal technique of liability leading to full compensation of the victim does not adequately address the economic agency problem posed in cases we refer to as conflicts of interest.

48. In cases of breach of a duty of loyalty, fiduciary law uses a remedy that is much more appropriate from an economic perspective: disgorgement or the transfer of all profits or gains the agent actually realized through his disloyal action to the beneficiary.[111] This remedy – or the *no profit rule* as this principle is also referred to – puts the disloyal agent in the position he would have been in without the breach of the duty of loyalty and thus eliminates the incentive for the agent to act disloyally.[112]

49. However, replacing the remedy of damages by disgorgement does not solve the enforcement problems of a duty of loyalty. From the perspective of the potential wrongdoer, the anticipated cost of a breach of duty is never equal to the actual cost of the remedy if imposed; in fact, the cost of the remedy should be discounted by the chance that it will be imposed, which most often will be less than 1. In the case of a duty of loyalty, this chance of being caught is far lower than with most other types of duties, because of the informational problems already discussed.[113] Therefore, even with a remedy such as disgorgement, the anticipated cost of being disloyal too often remains below the expected gains of such behavior.[114] This brings us to the second particularity of fiduciary law as a special technique to tackle conflicts of interest: the presumption of wrongdoing.

50. Under standard private law, the principal would have to prove that the agent breached his duty in order to be able to invoke remedies. Applied to a duty of loyalty, this would require the principal to show that the agent actually was inspired by other interests than the principal's, and as was already indicated, this most often will not be possible in practice.[115] Under fiduciary law, however, this burden of proof is replaced by a presumption that an agent faced with a conflicting personal interest has in fact

---

[111] *See* in general F.H. EASTERBROOK & D.R. FISCHEL (note 81), p. 425; D.A. DEMOTT (note 10), p. 882; T. FRANKEL (note 17), p. 827-827: "By classifying a relation as fiduciary, the law creates strong property rights for the entrustor as against his fiduciary." and "By declaring that a person is a fiduciary, the law shifts the beneficial ownership (the entitlement to benefit from the power [held by the fiduciary]) to the entrustor and leaves the fiduciary with mere legal title. This shift vests in the entrustor a property right in the power. The entrustor can enforce the prohibition against abuse of power directly against the fiduciary by strong remedies available to an owner of property".

[112] K.B. DAVIS, Jr. (note 17), p. 45-46; R. COOTER & B.J. FREEDMAN (note 10), p. 1052 and 1073, quoting *LAC Minerals Ltd. v. International Corona Resources Ltd.*, 61 D.L.R.4th 14, 47-48 (Can. 1989) ("The imposition of a remedy which restores an asset to the party who would have acquired it but for a breach of fiduciary duties or duties of confidence acts as a deterrent to the breach of duty and strengthens the social fabric those duties are imposed to protect."); W. BISHOP & D.D. PRENTICE (note 31), p. 309, quoting J. RAND in *Midcon Oil & Gas Ltd. v. New British Dominion Oil Co. Ltd.*, (1958) 12 D.L.R. (2nd) 705, p. 716: "[Equity] by an absolute interdiction […] puts temptation beyond the reach of the fiduciary by appropriating its fruits."

[113] *See supra* paragraph 14.

[114] R R. COOTER & B.J. FREEDMAN (note 10), p. 1052.

[115] *See supra* paragraph 14.

acted in furtherance of this interest.[116] In some cases, the fiduciary can escape by proving that his actions are objectively defensible and in the interest of the beneficiary, but in many cases the presumption is irrebuttable and hence effectively results in a *per se* prohibition of acting when confronted with a conflict of interest as any action in such circumstances will result in liability. In effect, these presumptions help reduce the incentive problem by raising enforcement probability.[117] Under the resulting prohibition for the agent to act when confronted with a conflict of interest – also often referred to as the *no conflict rule* – the only remaining risk for the principal is the possibility for the agent to be able to keep the fact that he has conflicting interests a secret.[118]

51. In theory, both characteristics of fiduciary law – the remedy of disgorgement and the presumption of wrongdoing when a conflict of interest is present – seem particularly appropriate to address the agency problem posed by conflicts of interest. Fiduciary law offers the principal a basis for realistic *ex post* settling up: if there is any reason to believe the agent might have behaved disloyally, he will have to transfer all gains he made to the principal. As a result, this remedy eliminates the *ex ante* incentive for the agent to act disloyally, as he will not anticipate any gain from disloyal behavior if he knows he will have to turn over these profits to the principal anyway. Fiduciary duties thus render disloyal behavior no longer in the interest of the agent and hence the conflict of interest effectively disappears. This makes fiduciary law in theory a good technique to ensure that principals will be prepared to in effect "trust" their agents to the extent required to realize efficient market outcomes.[119]

52. However, imposing fiduciary duties on asset managers poses many problems in modern commercial practice. As was shown earlier, financial institutions offering asset management services are almost necessarily confronted with conflicts of interest,[120] and thus fiduciary law would very often if not almost always require them to abstain from acting for the account of their clients. Also, applying the no profit rule would be impractical: most likely, a financial institution itself is not even aware of all indirect gains it could have realized because of its actions for the account of its clients. Fiduciary law, with all its strictness, was originally developed in a period when commercial and financial transactions and firms were relatively simple.[121] As a result, it does not fit well with the much more complicated financial services of today, the large scale at which

---

116 R R. COOTER & B.J. FREEDMAN (note 10), p. 1048 and 1053-55: "To overcome difficulties in proof, the law infers disloyalty from its appearance, presuming that a fiduciary will appropriate the principal's asset when it is in her self-interest to do so."

117 R. COOTER & B.J. FREEDMAN (note 10), p. 1054.

118 K.B. DAVIS, Jr. (note 17), p. 45.

119 Of course, fiduciary law developed from equity precisely in cases where the Chancery wanted to protect the "trust" or "confidence" one party had placed in another in order to make such relationships possible. *See* L.S. SEALY, "Fiduciary Relationships", *Cambridge Law Journal* (1962) 69, p. 69-72; D.A. DEMOTT (note 10), p. 880.

120 *See supra* section III.A.

121 *See* R. CRANSTON, "Conflicts of Interest in the Multifunctional Financial Institution", *Brooklyn Journal of International Law* 16 (1990) 125, p. 128; P. FINN, "Fiduciary Law and the Modern Commercial World", in E. MCKENDRICK (ed.), *Commercial Aspects of Trusts and Fiduciary Obligations*, Oxford: Clarendon Press, 1992, 7-42, p. 19-20; H. MCVEA (note 54), p. 147.

financial services that require loyalty are nowadays organized, or with the tendency to create multifunctional financial institutions that combine almost all financial services under one roof.[122] It is therefore not surprising that in practice fiduciary duties are not enforced as strictly as one would expect against financial institutions.[123] If they were, the indirect effect would be to preclude financial institutions from combining asset management with other financial services. This would turn the conduct rules created by fiduciary law into an effective structural bar, requiring disaggregation of multifunctional financial institutions.[124]

B. Regulatory Conduct of Business Rules

1. A Regulatory General Standard of Loyalty

53. EC harmonized financial regulation imposes a duty of loyalty on all asset managers. For individual portfolio management, Article 19(1) of the Market in Financial Instruments Directive ("MiFID"),[125] requires an investment firm to "act honestly, fairly and professionally in accordance with the best interests of its clients",[126] and under the Undertakings for Collective Investment in Transferable Securities Directive ("UCITS Directive"),[127] comparable requirements exist for collective portfolio management.[128]

54. But what does this add to the existing legal landscape? Recall that a duty to act in the exclusive interests of the customer is included in the asset management contract, at least implicitly, and therefore the investor can use contractual remedies under applicable national law if this duty is breached.[129] EC financial regulation reinforces this duty by

---

[122] H. MCVEA, "Conflicts of Interest – Regulatory Rules and the Common Law", in R. RIDER & M. ASCHE (ed.), *The Fiduciary, the Insider and the Conflict*, Dublin: Sweet & Maxwell, 1995, 131-148, p. 142; R. CRANSTON (note 67), p. 24; N.S. POSER (note 54), p. 165.

[123] *See* ST. COATES, "Conflicts of Interest in the Securities Industry", in B. RIDER & M. ASHE (ed.), *The Fiduciary, the Insider and the Conflict*, Dublin: Sweet & Maxwell, 1995, 104-130; N.S. POSER (note 54), p. 122; P. FINN (note 121), p. 13; B. RIDER, "Conflicts of Interest: An English Problem?", in G. FERRARINI (ed.), *European Securities Markets. The Investment Services Directive and Beyond*, London: Kluwer Law International, 1998, 149-164, p. 164.

[124] *Cf.* P.R. WOOD, "Financial Conglomerates and Conflicts of Interest", in R.M. GOODE (ed.), *Conflicts of Interest in the Changing Financial World*, London: The Institute of Bankers & Centre for Commercial Law Studies, Queen Mary College, University of London, 1986, 59-80, p. 59, saying that "[i]f one were to take [the strict fiduciary] standard as applying to the investment banking and dealing activities of the London financial conglomerate, it would be impossible to do business." *See also* N.S. POSER, "Conflicts of Interest within Securities Firms", *Brooklyn J. Int'l L.* 16 (1990) 111, p. 116.

[125] *See supra* note 1.

[126] Article 19(1), MiFID, is declared applicable to credit institutions by Article 1(2), MiFID.

[127] *See supra* note 1.

[128] *See* Article 10(2), UCITS Directive (supra note 1) ("[…] the management company […] must act independently and solely in the interest of the unit-holders.") and Article 5h, UCITS Directive ("[...] a management company: (a) acts honestly and fairly in conducting its business activities in the best interests of the UCITS it manages […]; (b) acts with due skill, care and diligence, in the best interests of the UCITS it manages [...].").

[129] *See* "Débats", in L. THÉVENOZ (ed.), *Aspects Juridiques de la Gestion de Fortune – Legal Aspects of Investment Management*, Brussels: Bruylant and Berne: Stämpfli, 1999, p. 125-132; L. ENRIQUES (note 3), p. 4; P. WERY, "La gestion de fortune au regard du droit commun du mandat", in B. TILLEMAN & B. DU LAING (ed.), *Bankcontracten*, Series Recht en Onderneming No. 9, Brugge: die Keure, 2004, 319-341, paragraph 15 at p. 333;

elevating it to a regulatory norm applicable to all financial institutions offering asset management services. Thus, as a consequence of the transposition of MiFID in national law of the Member States, not only has a duty of loyalty become a *mandatory* element of asset management contracts, the compliance with this principle can now also be supervised and breaches sanctioned by the national public supervisory institutions.[130] This approach is typically justified by the rationale that, as previously discussed, the loyalty of these professionals to the interests of their clients not only concerns these individual clients, but also more general or systemic interests, such as the integrity and efficiency of the market and the financial system, the confidence investors place therein, and the function these systems thus can perform in our society.[131]

55. As such, because of the public interest involved, regulatory oversight seems appropriate,[132] given the justifications for specific legal intervention we have identified earlier.[133] In many cases, the existence of a conflict of interest might not actually hurt the individual investor, because the market price he pays for the service the asset manager offers reflects the risk posed by the conflicts of interest.[134] In that case, the investor will not feel any need to bring a private action against the asset manager. But as discussed earlier, even in such a situation, it is in the general interest that conflicts of interest are not abused.[135] For such cases, where only general interests are damaged, public authorities seem to be best placed to decide in individual cases whether an action against the financial institution is warranted.[136]

56. But the European legislator seems to go further than this enforcement based rationale: it seems to take the view that in order to protect the investor, a regulatory standard requiring investment firms to act in the interest of their clients is necessary because the normative content of this rule offers the investors extra protection. The Commission even goes as far as to refer to this regulatory approach as reinforcing the *fiduciary duties* of investment firms.[137]

P. WÉRY, *Le mandat*, Répertoire notarial, Vol. 9, Principaux contrats usuels, Livre 7, Brussels: Larcier, 2000, 151 *et seq*.

[130] Articles 8 and 51(1), MiFID.

[131] *Cf. also* K.J. HOPT (note 56), p. 63.

[132] However, not everybody is convinced that the national supervisory authorities will be equipped to perform the task of reviewing the behavior of firms under the very broad standards of fairness and honesty. *See* for instance L. ENRIQUES (note 3), p. 14.

[133] *See supra* section III.C.

[134] *See supra* paragraphs 34-35 and 44.

[135] *See supra* Section III.C.3. One could say that the externalities of conflicts of interest justify public regulation and proactive law enforcement by regulators. *Cf.* L. ENRIQUES (note 3), p. 4.

[136] One could also argue that the behavior of financial institutions in such cases does not violate the rule in Article 19(1), MiFID, as the interests of the clients are not particularly hurt, but are caught by the general rule in Article 25(1), MiFID, requiring the investment firms to act "honestly, fairly and professionally and in a manner which promotes the integrity of the market." The Commission considered it desirable to split the general principle of loyalty between these two provisions because the "[i]mplementation of the […] provision [in ISD 1993 containing conduct of business rules as one of the mainstays of investor protection] has been hampered by […] overlap with market integrity issues […]." *See* COM(2002) 625 final (note 60), p. 82.

[137] Thus, for instance, the Commission commented that "[i]n terms of concrete policy and technical choices, […] [its] proposed approach at level 2 consists in reinforcing the fiduciary duties of the investment firms towards their

However, the Commission's view seems to be based on a misunderstanding of the characteristics that render a duty *fiduciary* as opposed to a standard duty of loyalty. As indicated earlier,[138] fiduciary duties are not special because of the normative content of the general principle involved ("though shall act loyally"): that content is part of *any* duty of loyalty, whether it is imposed by fiduciary law or by standard private law. What differentiates a fiduciary from a non-fiduciary duty of loyalty is the remedy attached to a breach (disgorgement instead of damages, resulting in an effective no profit rule) and the principle that a breach is deduced from the mere appearance of impropriety (presumption of disloyalty, resulting in an effective no conflict rule).

In general, continental European civil law does not know such general rules applicable to situations involving conflicts of interest.[139] In other words, in most European countries there are no "fiduciary" duties to "reinforce" by regulation. But more importantly, nowhere in the MiFID or in any other existing European regulation, nor in the considered working versions of Level 2 regulations, can the remedies and presumptions that characterize duties as fiduciary be found. Of course, the application of the European rule in national courts can effectively turn it into something like a fiduciary duty when it is backed up by equitable remedies under national law. However, that will only be possible in common law jurisdictions with national law that already imposes fiduciary remedies and is not a consequence of MiFID or any other European law.

57. Apart from the possible discussion whether it would be desirable to impose fiduciary duties on financial institutions,[140] it does not help matters – nor does it sustainably underpin public confidence – if investors are given the false impression that they are owed a more special protection than "normal" legal duties would offer them, while in fact they are not.[141] Breaches of the general rule in Article 19(1), MiFID, will offer the

---

clients (and especially towards retail clients)", and "[s]ince […] [it] proposed reinforced fiduciary duties, in formulating the information requirements as part of the conduct of business rules, […] [it] took the view that the information which firms must give to their clients should be limited to those elements that are essential for the client to understand the nature of his relationship with the firm, and the services and instruments offered by the firm. Accordingly, […] [it has] tried as far as possible to avoid overloading clients, and retail clients in particular, with information that would be of no immediate use to them." *See* EUROPEAN COMMISSION, INTERNAL MARKET AND SERVICES DG, *Explanatory Note to Working Document ESC/23/2005 and to the Addendum of the Working Document ESC/17/2005 on Investment Research*, Working Document ESC/24/2005, 11 July 2005, p. 2.

[138] *See supra* Section IV.A, in particular paragraphs 46-50.

[139] Some continental European private law systems might for instance know some variation on the rule that a legal agent cannot in a transaction represent both sides. However, in many countries, neither the courts nor academic opinion seems to be willing to interpret this rule as a specific application of a wider standard prohibiting any person under a duty of loyalty from entering into a situation that creates a conflict of interest for him. *See* A. MEINERTZHAGEN-LIMPENS, "La représentation et les conflits d'intérêts en droit comparé", in *Les conflits d'intérêts*, Les conferences du Centre de Droit Privé, U.L.B., Vol. VII, Brussels: Bruylant, 1997, 261-295, p. 273-277, nrs. 14-18; K.J. HOPT (note 56), p. 71-72.

[140] *Cf. supra* paragraph 52.

[141] In the shorter run, however, the false feeling of protection given to investors by the regulatory rules might cause them to overestimate the average value of the financial services they receive. Applying the lemons mechanism in reverse, this would lead to a market equilibrium at too high a level of services provided and price paid, a situation good for the financial industry but not optimal for society. *Cf.* D. MCGOWAN, "Some Realism About Parochialism: The Economic Analysis of Legal Ethics", University of San Diego School of Law, Legal Studies Research Paper Series, Research Paper No. 07-20, October 2005, p. 12, available in the Social Sciences Research Network electronic library at <www.ssrn.com/abstract=819984>.

investor only the remedies already available under national private law,[142] meaning in most continental legal systems only compensation of damages, making this loyalty principle also virtually unenforceable in practice.[143]

58. As a consequence, the imposition of a regulatory duty of loyalty does not by itself help to solve conflicts of interest problems. Actually, to put it cynically, the presence of such a duty is precisely what creates a legal conflict of interest, so the only thing that is accomplished by imposing a duty of loyalty in a situation where such a duty is not already part of the contractual arrangement would be to transform an existing economic conflict of interests into a legal conflict of interest.[144] Solving the problems the resulting conflicts of interest might pose will necessarily require additional measures such as providing effective remedies that take into account the challenges posed by the enforcement of a duty of loyalty that were discussed above. Therefore, it might be interesting to investigate and debate whether it would not be preferable to introduce not only a European regulatory rule requiring asset managers to act loyally or in the best interests of their clients, but also to provide investors all over the EU with uniform appropriate remedies and evidentiary rules applicable to this norm geared at addressing the real concerns posed.

2. Imposing Specific Rules for Asset Management Services?

59. If the duty of loyalty would only be imposed by general private law, as a "vague" or "open" standard, fine tuning the application of the principle to specific cases or financial services would in fact be left to the judiciary. Given the relatively limited amount of litigation between individual investors and asset managers, which results in large part from the remedies problems discussed above, few helpful guidelines might develop, resulting in significant uncertainty for asset managers and investors alike.

60. Including the general duty to act in the interest of the client in public regulation of investment firms brings with it the opportunity to create divers specific, precise regulatory prescriptions or prohibitions based on this general principle tailored for different financial activities, transactions or situations. The MiFID itself, referred to as the Level 1 text, does contain some conduct of business rules that can be considered as such specifications of the general principle of loyalty, such as the know-your-customer prin-

---

[142] The conduct of business rules included in the ISD turned out to offer the investor very differing kinds of remedies under the different national laws, and in some member countries could not even be relied upon by private parties in a dispute against an investment firm because they were interpreted as being only relevant in the relation between the financial institution and the supervisory authorities. *See* M. TISON, "Conduct of Business Rules and their Implementation in the EU Member States", in G. FERRARINI, K.J. HOPT & E. WYMEERSCH (eds.), *Capital Markets in the Age of the Euro. Cross-Border Transactions, Listed Companies and Regulation*, London: Kluwer Law International, 2002, 65-99, p. 77-80. Arguably, the MiFID changes this and requires the Member States to allow private parties to enforce its conduct of business rules in liability suits. *See* M. TISON, "Financial Market Integration in the Post-FSAP Era. In Search of Overall Conceptual Consistency in the Regulatory Framework", to be published in G. FERRARINI & E. WYMEERSCH (eds.), *Investor Protection in Europe: Regulatory Competition and Harmonization*, Oxford: Oxford University Press, forthcoming in 2006.

[143] *See supra* paragraphs 47 and 49-50.

[144] *See supra* paragraph 6.

ciple as adapted to different services and different types of clients,[145] the best execution principle,[146] and the client order handling rules.[147] Moreover, the MiFID also foresees implementation in so-called Level 2 Commission directives or regulations of the general principle in Article 19(1) to further specify and flesh out the general rule.[148] Unfortunately, the European Commission apparently is not planning to issue many Level 2 rules implementing the general duty of loyalty of Article 19(1), MiFID.

61. Thus far really only one implementing rule specifying how the general duty should be understood in specific circumstances has been considered, namely a rule relating to the acceptance of inducements by the investment firm. The considered working version of the rule starts from the position that an investment firm shall not, in relation to the provision of an investment or ancillary service to a client, receive or offer any fee, commission or non-monetary benefit.[149] However, two exceptions are included. First investment firms are of course allowed to receive such benefits paid or provided by the client.[150] Second, benefits paid or provided by a third person are allowed but only on the dual conditions that (1) the existence, nature and amount are clearly disclosed to the client prior to the provision of the investment service,[151] and (2) the benefit enhances the quality of the relevant service to the client and does not impair compliance with the firm's duty to act in the best interests of the client.[152] Disclosure must be comprehensive, accurate, understandable to the client, but can be general in nature, provided that the firm undertakes to disclose further details at the request of the client.[153] The Commission commented further that "some more thought should be given to this issue, it would be preferable to categorize the different kinds of inducements and provide for a differentiated treatment according to each category so as to maintain the flexible policy where that is appropriate, while imposing more restrictive requirements where necessary to protect the interests of clients."[154]

---

[145] Articles 19(4), (5) and (6), MiFID; *see infra* paragraphs 63 *et seq.*

[146] *See* Article 21, MiFID.

[147] *See infra* paragraphs 67 *et seq.*

[148] According to Article 19(10), MiFID, the Commission shall adopt implementing measures to ensure that investment firms comply with the general duty of loyalty included in Article 19(1), MiFID, when providing investment or ancillary services to their clients, taking into account the nature of the services offered or provided to the client, the type, object size and frequency of these transactions, the nature of the financial instruments involved, and the retail or professional nature of the client. The idea behind this system was apparently that the result would be more akin to a European conduct of business rulebook rather than high-level principles at a European level with the detail being left to national implementation measures as was the case under the ISD. *See* J. HERBST, "Revision of the Investment Services Directive", *Journal of Financial Regulation and Compliance* 11 (2003) 211, p. 215.

[149] *See* Article 25(1), *Draft Commission Working Document on Conduct of Business Rules, Best Execution, Client Order Handling Rules, Eligible Counterparties, Clarification of the Definition of Investment Advice and Financial Instruments*, Working Document ESC/23/2005-Rev2, 29 September 2005.

[150] Article 25(1)(a), ESC/23/2005-Rev2 (note 149).

[151] Article 25(1)(b)(i), ESC/23/2005-Rev2 (note 149). *Cf.* Paragraph 17 in Box 9 in *CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments – 1st Set of Mandates*, CESR/05-024c, January 2005, p. 58.

[152] Article 25(1)(b)(ii), ESC/23/2005-Rev2 (note 149). *Cf.* Paragraph 9 in Box 7 in CESR/05-024c (note 151), p. 44.

[153] Article 25(2), ESC/23/2005-Rev2 (note 149).

[154] ESC/24/2005 (note 137), p. 3.

62. Remarkable is that the Committee of European Securities Regulators ("CESR"), which advises the Commission on these matters,[155] initially had considered a Level 2 rule based on the general principle of Article 19(1), MiFID, that was slightly more specific and would have required "[t]he transactions carried out by an investment firm that provides portfolio management services to retail clients […] [to] be exclusively motivated by the interests of such clients and in accordance with the management objectives set out in the retail client agreement."[156]

This proposed rule apparently drew heavy criticism from the industry. First, some respondents in CESR's consultation process took the view that obliging the firm to act in accordance with the retail client agreement is redundant, as the firm would be bound by such agreement anyway.[157] This is true, of course, but not including the duty to comply with a private law contract in the regulations, undermines the authority of the public supervising institutions to monitor and if necessary sanction breaches that do not at the same time involve a breach of a regulatory rule. Second, some respondents apparently "objected to the concept of 'exclusive motivation' as being too absolute, saying that other legitimate reasons, such as the interest of the firm in attracting additional clients by achieving portfolio performance superior to that of its competitors, should naturally not be ruled out."[158] This is disturbing. In most cases the interest of the firm in attracting additional clients by achieving superior portfolio performance does not conflict with the interests of the clients. This means that under most circumstances a rule imposing exclusive loyalty to the interests of the clients would not prohibit the firm to strive for such superior portfolio performance, giving the industry representatives no reason to object to the proposed rule. The only instances in which the proposed rule would prohibit the firm furthering its interest in achieving superior portfolio performance would be when this would not be in the interests of existing clients, and that is only the case when the asset manager overinvests in the services it renders, *i.e.* when the asset manager actually spends *and charges* more than the optimal effort seen from the perspective of the existing clients. Do industry representatives really take it to be legitimate for asset managers to overinvest in their efforts and charge their clients for it?

---

[155] The provisions in the MiFID have to be implemented by Level 2 measures by the EU Commission under the so-called Lamfalussy method. *See* B. SOUSI, "La Procédure Lamfalussy à l'épreuve de la directive concernant les marches d'instruments financiers", *Euredia – European Banking & Financial Law Journal – Revue européenne de Droit bancaire & financier* (2004/2) 209-221; for this legislative method in general, *see e.g.* E. FERRAN, *Building an EU Securities Market*, Cambridge: Cambridge University Press, 2004, p. 61-84; N. MOLONEY, *EC Securities Regulation*, Oxford: Oxford University Press, 2002, p. 861-871.

[156] *See* Rule 2 in Box 7, *CESR's Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments – 2nd Set of Mandates, Consultation Paper*, CESR/04-562, October 2004, p. 42. This rule already existed as a CESR Standard for Investor Protection (*see* Principle 137 in THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS, *A European Regime of Investor Protection – The Harmonization of Conduct of Business Rules*, CESR/01-014d, April 2002, p. 25), after having been proposed by its predecessor FESCO in 2001 (*see* Standard 151 in FESCO, *Standards and Rules for Harmonizing Core Conduct of Business Rules for Investor Protection, Consultative Paper*, Fesco/00-124b, February 2001, p. 32).

[157] *See CESR's Technical Advice on Level 2 Implementing Measures on Mandates of the First Set where the deadline was extended and the Second Set of Mandates – Markets in Financial Instruments Directive – Feedback Statement*, CESR/05-291b, April 2005, p. 21.

[158] CESR/05-291b (note 157), p. 21.

Whatever may be the reason, in the end CESR decided not to maintain the rule in its final advice to the Commission,[159] and thus far, the Commission has not indicated it is contemplating to propose such a rule.

3. Specific Requirements of Suitability of Investment Decisions

63. One of the specifications or applications of the general principle of loyalty for portfolio management services can be inferred from Article 19(4), MiFID. This Article contains the adaptation of the "know your customer" principle to asset management and investment advice.[160] As such, it only imposes a duty on the asset manager to gather information. The information to be collected relates to (1) the client's knowledge and experience in the relevant investment field,[161] (2) the client's financial situation,[162] and (3) the client's investment objectives,[163] and information collected is used to judge what is called the "suitability" of the investment recommended or entered into. This contrasts with the know your customer principle as applicable to other investment services, where only information relating to the client's knowledge and experience in the relevant investment field has to be collected, which must serve to judge what is called the "appropriateness" of the envisaged investment service or product.[164]

64. The distinction between the rules applicable to asset management and investment advice on the one hand and other investment services on the other goes further than a

---

[159] *See* CESR/05-291b (note 157), p. 21-22.

[160] Article 19(4), MiFID reads: "When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm *to recommend* to the client or potential client the investment services and financial instruments that are suitable for him" (emphasis added). This Level 1 text is not optimal, as there are no "recommendations" in the case of portfolio management: the investment firm will execute the investment decisions itself, albeit for the account of the customer. This terminological problem was noticed by CESR, and therefore its advice to the Commission on the Level 2 measures (*see CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments – 1st Set of Mandates where the deadline was extended and 2nd Set of Mandates*, CESR/05-290b, April 2005, p. 26; *see also* already CESR/04-562 (note 156), p. 42) and the possible Level 2 measures based on this provision considered by the Commission (for the most recent version, *see* Article 10(1), ESC/23/2005-Rev2 (note 149), do not suffer from this shortcoming.

[161] According to the Level 2 proposal considered by the Commission, this would include information on the types of services, transactions and financial instruments with which the client is familiar, the nature, volume, frequency of the client's transactions in financial instruments and the period over which they have been carried out, and the level of education and profession or relevant former profession of the client. *See* Article 10(4), ESC/23/2005-Rev2 (note 149). This is analogous to CESR's advice on the issue (*see* Rule 1.a) in Box 10 in CESR/05-290b (note 160), p. 27) and not very different from what was already foreseen in CESR's 2002 Conduct of Business Rules (CESR/01-014d (note 156), p. 46, footnote 15).

[162] According to the Level 2 proposal considered by the Commission this would include information on his financial situation, the source and extent of his regular income, his assets, including liquid assets, investments and real property, and his regular financial commitments (*see* Article 10(3), ESC/23/2005-Rev2 (note 149), again very similar to CESR's advice (Rule 1.b) in Box 10 in CESR/05-290b (note 160), p. 27).

[163] According to the Level 2 proposal considered by the Commission this would include information on the length of time for which the client wishes to hold the investment, his preferences regarding risk taking (risk profile), and the purposes of the investment (Article 10(3*bis*), ESC/23/2005-Rev2 (note 149)), which is also what CESR advised (Rule 1.c) in Box 10 in CESR/05-290b (note 160), p. 27) and what was already the rule in the CESR 2002 Conduct of Business Rules (CESR/01-014d (note 156), p. 46).

[164] *See* Article 19(5), MiFID; Article 10(4), ESC/23/2005-Rev2 (note 149).

difference in the kind or quantity of information to be collected. The two regimes also reveal two different rationales as to why the information is necessary, indicating different underlying meanings of the general duty of Article 19(1), MiFID, as applied to portfolio management and investment advice on the one hand and other investment services on the other.

In the case of investment advice and portfolio management, the investment firm apparently has a duty to choose investments that are suitable for its client. This implies a margin of discretion for the investment firm coupled with a duty of loyalty, requiring the firm to decide exclusively based on the interests of the customer. In order to be able to properly ascertain what are the interests of a particular investor, the asset manager will need the kind of information mentioned in Article 19(4), MiFID.

In the case of other investment services, however, the investment firm does not have a duty to choose for the client. Here, in principle, the client chooses himself what is in his best interest, and the investment firm only helps the customer execute the decision. Hence, the only underlying duty Article 19(5), MiFID, assumes, is a duty for an investment firm to warn an investor when he is making decisions with potential consequences he does not really understand,[165] and the investment service provider is not required to substitute its own judgment whether the envisaged investment decision is or is not in the interests of the investor. In these cases, the investment firm apparently does not have a duty of loyalty.[166]

65. In this light, it makes perfect sense that the information duties included in Article 19(5), MiFID, are not applicable when investment services are offered to professional clients.[167] A professional client under the MiFID is "a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs",[168] so the underlying duty assumed by Article 19(5), MiFID, will not apply.[169] But the problem tackled by Article 19(5), MiFID, is a problem situated at the time of contracting. It is a part of the law relating to pre-contractual

---

[165] *See* Article 19(5), 2nd paragraph, MiFID: "In case the investment firm considers […] that the product or service is not appropriate to the client or potential client, the investment firm shall warn the client or potential client."

[166] *Cf.* B. INEL, "Investment Advice and Execution-Only Services in the Single European Market: The New FIMD Regime", *Euredia – European Banking & Financial Law Journal – Revue européenne de Droit bancaire & financier* (2004/2) 301, p. 311-312, characterizing the duty imposed by Article 19(5), MiFID, as a "light-touch profiling system for clients not requiring a personalized assessment. In this sense, it is meant to be distinct from investment advice."

[167] According to the Commission proposed Level 2 rules, an investment firm in effect does not have to collect the relevant information for Article 19(5), MiFID, from a professional client, as "an investment firm shall be entitled to assume that professional clients [...] have the level of experience and knowledge […], in relation to those products, transactions and services for which they are classified as professional clients" in order to "understand the risks involved in the transaction or in the management of the portfolio". *See* Article 10(2), ESC/23/2005-Rev2 (note 149).

[168] *See* Annex II to the MiFID, *OJ L* 145/43 of 30 April 2004.

[169] Therefore, the Commission plans to include a recital in its Level 2 implementation regulation stating: "An envisaged transaction, product or service shall be deemed to be appropriate for the purpose of Article 19(5) of the Directive to the extent that the client is classified as a professional client in relation to the envisaged transaction, products or service". *See* ESC/23/2005-Rev2 (note 149), p. 13 in footnote 18.

information provision and as such has nothing to do with the conflicts of interest problem.

66. However, it is more questionable whether it is consistent with the rationale of Article 19(4), MiFID, to excuse the asset manager from verifying whether envisaged investment decisions for the account of a professional investor are such that the investor is able financially to bear the risk of any loss that this investment might cause. Nonetheless, this was what the Commission in its initial drafts seemed to be considering for the Level 2 implementation of Article 19(4), MiFID.[170]

An asset manager takes investment decisions for the account of the investor, so it is the asset manager that has to make a judgment as to the desirability of the transactions given the interests of the investor. According to the Level 1 text, this desirability/ suitability is to be judged based on the client's "financial situation and his investment objectives", meaning that these elements at least are a part of the interests of the investor that have to be taken into account. The fact that the investment firm is justified in assuming that the professional client "possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs", is not relevant in this context, as it is not the client itself that is making investment decisions. If it is the duty of the asset manager to make investment decisions in the best interests of the professional client, it also has to know what these interests are, even though its client is a professional. This is a conflicts of interest issue, not existing at the time of contracting but during the performance of the contract, and therefore no distinction between the types of clients is warranted.[171]

Hopefully this was the reason why the Commission in the most recent version of its Level 2 Working Document qualified the rule so as to limit the presumption that professional clients are able to bear the financial risk of any loss that the investment may cause to investment advice thereby implicitly excluding asset management, leaving the duty of an asset manager under Article 19(4), MiFID, to collect information about its client's ability to bear risk fully operational in the case of professional clients.[172]

4. Client Order Handling Rules

67. The MiFID requires investment firms to implement and maintain "procedures and arrangements which provide for the prompt, fair and expeditious execution of client

---

[170] *See* Article 11(1), *Draft Commission Working Document on Conduct of Business Rules, Best Execution, Client Order Handling Rules, Eligible Counterparties, Clarification of the Definition of Investment Advice and Financial Instruments*, Working Document ESC/23/2005, 7 July 2005: "[a]n investment firm shall be entitled to assume that professional clients are […] able financially to bear the risk of any loss that the investment may cause", still present in the first revision of this Working Document: Article 11(2)(b), *Draft Commission Working Document on Conduct of Business Rules, Best Execution, Client Order Handling Rules, Eligible Counterparties, Clarification of the Definition of Investment Advice and Financial Instruments*, Working Document ESC/23/2005-Rev1, 9 September 2005.

[171] *See supra* paragraph 39.

[172] *See* Article 10(2)(b), ESC/23/2005-Rev2 (note 149).

orders, relative to other client orders or the trading interests of the investment firm."[173] These so-called client order handling rules do not judge the quality of the execution of an order for the account of a client relative to conditions available in the wider market place, as the best execution duty does.[174] Fairness and expediency in this regard should be understood as referring to a comparison with the handling of other client orders or proprietary transactions by the investment firm.[175]

68. This provision is particularly aimed at tackling the conflicts that can arise between the interests of several clients using the same investment service from the investment firm.[176] It contains an important modification of the general duty of loyalty applicable to the relationship with each individual client: instead of being required to maximize the interests of each individual client, this rule makes clear that the firm is only bound to treat each investor "fairly" as compared to other investors. While the personal interests of an investment firm under the duty of loyalty may never enter the equation, the interests of other clients apparently have to be taken into account so as to treat clients equally. Applied to a situation of a conflict of duties towards several clients, a duty of loyalty is transformed into a duty of equal treatment.

This principle thus has to be considered as a *moderation* or limitation of the fiduciary duty of loyalty, which in its strictest form would make it difficult for a fiduciary to have several competing clients.[177] In effect, the implementing rules the Commission is considereing under this principle in effect eliminate the conflicts of interest that can arise between the different competing clients of an investment firm by partially replacing the duty of loyalty the firm owes its clients with a duty that specifically prescribes what the firm is supposed to do in certain situations.[178]

69. For instance, the Commission is considering to require an investment firm to carry out client orders sequentially and promptly, unless the nature of the order or the prevailing market conditions make this either impracticable or not in the best interests of the client.[179] Once executed, orders have to be promptly and accurately recorded and allocated.[180]

It is also considered that aggregation of orders for several clients or of client orders and orders for the personal account of the firm will only be allowed if it is likely that this will not work to the overall disadvantage of any client involved, the investment firm

---

[173] Article 22(1), MiFID.

[174] The best execution duty, as included in Article 21(1), MiFID, requires investment firms to "take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order."

[175] COM(2002) 625 final (note 60), p. 84.

[176] *See supra* Section III.B.1.

[177] *Cf. supra* paragraph 52.

[178] *See supra* paragraph 21.

[179] Article 21(1)(b), ESC/23/2005-Rev2 (note 149). This is very similar to existing CESR's 2002 Conduct of Business Principles: CESR/01-014d (note 156), Rules 97 and 196.

[180] Article 21(1)(a), ESC ESC/23/2005-Rev2 (note 149).

has disclosed to each client involved that the effect of aggregation might work to its disadvantage in relation to a particular order, and the investment firm has established and effectively implements an order allocation policy providing for the fair allocation of such orders and transactions in sufficiently precise terms.[181] The allocation of aggregated orders for a client's account and for the firm's own account may not be detrimental to any client.[182] If an aggregated order is only partially executed, the related trades shall be allocated according to the firm's allocation policy.[183] But when client orders have been aggregated with transactions for the own account of the firm, allocation should give the client priority. Only if the firm can demonstrate on reasonable grounds that without the aggregation it would not have been able to carry out the order on such advantageous terms, it is allowed to allocate the order proportionally.[184]

70. There have been discussions about whether the MiFID's client order handling principle is applicable to the service of portfolio management. At first sight, the Level 1 text might argue against such application, as Article 22(1), MiFID, applies to the "execution of client orders" and one could argue that an investment firm does not receive any "orders" from its clients and does not "execute" an order when it accesses execution venues indirectly.[185] Some respondents in CESR's consultation argued that this rule was drafted for sell side firms only, in particular brokers and dealers. They pointed out that portfolio management is not a transaction service and should not be regulated as such.[186] However, as CESR correctly pointed out, this reasoning ignores the fact that poor or unfair execution has an adverse impact on portfolio performance and is therefore relevant for a duty relating to the resulting global yields.[187] As a result, the Commission is considering a Level 2 rule that submits portfolio managers to the rules for client order handling.[188]

---

[181] Article 22(1), ESC/23/2005-Rev2 (note 149). CESR had proposed much the same requirements. *See* Paragraph 8 en 9 in Box 17, CESR/05-290b (note 160), p. 44, as were already included in the 2002 CESR Conduct of Business Principles. *See* Rules 96, 99, 100 and 108 in CESR/01-014d (note 156).

[182] Article 23(1), ESC/23/2005-Rev2 (note 149). This proposed rule is analogous to CESR's advice: Paragraph 12 in Box 17, CESR/05-290b (note 160), p. 44.

[183] Article 22(2), ESC/23/2005-Rev2 (note 149). *Cf.* CESR's proposal, Paragraph 14) in Box 17, CESR/05-290b (note 160), p. 44. This was also the rule in the 2002 CESR Conduct of Business Principles; *see* Rule 115 in CESR/01-014d (note 156), p. 22.

[184] Article 23(2), ESC/23/2005-Rev2 (note 149); quasi similar in CESR's advice: Paragraph 15) in Box 17, CESR/05-290b (note 160), p. 44.

[185] *CESR's Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments – Aspects of the definition of Investment Advice and of the General Obligation to Act Fairly, Honestly and Professionally in the Best Interests of Clients – Best execution – Market Transparency, Second Consultation Paper*, CESR/05-164, March 2005, p. 15, paragraph 10.

[186] CESR/05-164 (note 185), p. 18, paragraph 25.

[187] CESR/05-164 (note 185), p. 18, paragraph 26.

[188] *See* Article 18(2), ESC/23/2005-Rev2 (note 149): "Member States shall require as appropriate investment firms providing the service of portfolio management to comply with the obligations under Article[…] 22(1) of the Directive when carrying out decisions to deal on the basis that […] references in […] [that] Article[…] to executing orders shall be treated as references to carrying out decisions by the investment firm to deal in financial instruments on behalf of its client". *Cf.* CESR's analogous advice: Paragraph 1 in Box 13 in CESR/05-290b (note 160), p. 37.

71. Unfortunately, however, replacing the duty of loyalty as applicable to order handling by a rule specifically prescribing equal treatment of or specific consent by the investors, which is what the order handling policies do, is only of limited use when applied to the service of asset management. Here, the problem not only involves the timing of the execution and manner of allocating executed orders among clients, but more fundamentally turns around the timing and allocation of the investment decisions resulting in these orders. Once the decisions are taken, such order handling rules can ensure that execution is fairly distributed among clients, but the order handling rules as such do not influence whether the *investment decisions* themselves are fairly "distributed" among the clients. To give just one example, CESR stressed that not allowing an investment firm to benefit when aggregated orders for its own and for clients' accounts are only partially executed in cases where not aggregating those orders would have resulted in worse execution conditions for the customers, would take all incentives away for investment firms to aggregate orders in such circumstances, ultimately hurting the investors.[189] But how does one verify that the firm did not come up with the decision to order for the account of its clients precisely because it could use such orders to aggregate them with its own order to realize better conditions? While for execution purposes an equal treatment rule might be practical and sufficient, such a rule would become impossible to enforce when applied to the investment decisions themselves and hence to asset management.

C. Specific Measures to Tackle Conflicts of Interest

72. European regulation requires multifunctional financial institutions offering investment services to "maintain and operate effective organizational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest […] from adversely affecting the interests of its clients."[190] Management companies of UCITS have to be "structured and organised in such a way as to minimise the risk of UCITS' or clients' interests being prejudiced by conflicts of interest […]".[191]

73. It is interesting that both texts do not expect the financial firm to prevent conflicts of interest from arising, as general fiduciary law would require.[192] Instead, the rules only require organizational measures that are designed to prevent existing conflicts of interest from *adversely affecting* or prejudicing the interests of clients.[193] One could say that

---

[189] *Cf.* CESR/05-291b (note 157), p. 39: "CESR believes it is important to maintain the general principle of priority to client orders in the allocation of partial fills, especially because of the risk of abuse. However, it accepts that this risk needs to be weighed against the benefits of allowing clients to benefit from the aggregation of their orders with own account transactions, which may be lost if clients are provided with priority in all cases."

[190] Article 13(3), MiFID. This provision does not fundamentally differ from the corresponding rule in Article 10, ISD, requiring the investment firm to be "structured and organized in such a way as to minimize the risk of clients' interests being prejudiced by conflicts of interest between the firm and its clients or between one of its clients and another."

[191] Article 5f, UCITS Directive.

[192] *See supra* paragraph 50.

[193] *See also* CESR/05-024c (note 151), p. 41.

the investment firms are required to organize their operations in such a way as to neutralize the possible adverse impact of conflicts of interest on clients.

1. Which Conflicts of Interest?

74. To determine which those conflicts of interest are, the regulation requires an investment firm to spend reasonable effort to identify the conflicts of interest with which it is confronted.[194] According to the working draft of the Commission for Level 2 implementation, the firm has to draw up, maintain and implement an effective conflicts of interest policy which as a first component shall identify, according to the specific investment services, activities, and ancillary services the firm offers, the circumstances that constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of a client.[195]

75. But what does it mean for the "interests of clients'" to be "negatively affected", "prejudiced" or "damaged"? We have seen that the most fundamental economic problem of conflicts of interest in institutions functioning in a sufficiently competitive market environment is not that the individual client pays for more than he receives.[196] Because of market forces, most conflicts of interest – when not completely remaining secrets – will eventually result in an adjusted market price and demand for the service involved. In such circumstances, it is hard to maintain that the interests of the clients are prejudiced or negatively affected, as these clients did not bargain nor pay for more than what they got, albeit that what they get is a riskier transaction than they would have preferred. The essence of the agency problem lies in the suboptimal market equilibrium that will result under these circumstances. Therefore, even if the interests of the clients are not damaged, because they anticipated the risk that the conflicts of interest pose, the problem persists and should be tackled. However, the MiFID seems to leave such instances untouched. This indicates to us that the legislator views conflicts of interest too much as an investor protection problem and not enough as a market efficiency issue.

76. The Level 1 text of the MiFID mandates the Commission to adopt Level 2 measures that establish criteria for determining the types of conflict of interest intended.[197] But instead of giving criteria that would help to interpret the Level 1 text in a general, systematic way, the Commission prefers giving a "clear, although open, list of the generic situations that should be treated […] as conflicts of interest detrimental to the client for the purposes of the MiFID."[198] The Commission preferred this method because of the

---

[194] Article 18(1), MiFID. L. ENRIQUES (note 3), p. 5, calls this a "red flag" system.

[195] For the most recent working version, *see* Article 21(2)(a), EUROPEAN COMMISSION, INTERNAL MARKET AND SERVICES DG, *Organisational Requirements and Identification, Management and Disclosure of Conflicts of Interest by Investment Firms*, Working Document ESC/17/2005–Rev3, 27 September 2005.

[196] *See supra* Sections III.C.1 and III.C.3.

[197] Article 18(3)(b), MiFID.

[198] EUROPEAN COMMISSION, INTERNAL MARKET AND SERVICES DG, *Explanatory Note: Main Differences between Working Document ESC/17/2005 and the CESR Level 2 Advice*, Working Document ESC/18/2005, 13 May 2005, p. 5.

legal certainty it brings.[199] The list as considered includes five situations:[200] (1) an action is likely to create a financial gain or avoid a financial loss for the investment firm or a person in some way related to the firm, at the expense of the client, (2) the firm or a person in some way related to the firm has an interest in the outcome of an action which is distinct from the client's interest in that outcome, (3) the firm or a person in some way related to the firm has an incentive to favor the interests of one or more clients over the interest of another or other clients, (4) the firm or a person in some way related to the firm carries on the same business as the client, and (5) the firm or a person in some way related to the firm receives from a third person an inducement in relation to a service provided to the client other than the standard commission or fee for that service.

2. Structural and Organizational Measures

77. Under the MiFID, the Commission has to implement Level 2 rules that "specify the concrete organisational requirements to be imposed on investment firms performing different investment services and/or activities and ancillary services or combinations thereof."[201]

78. According to the considered rules, the organization of the investment firm should "ensure that relevant persons engaged in different business activities involving a conflict of interest […] carry on those activities with an adequate degree of independence."[202] For the sake of clarity and certainty, the Commission considers a list of organizational measures that will be mandatory if they are appropriate in light of the type of conflicts the firm is subject to.[203] This list includes:[204] (1) measures to prevent inappropriate exchange of information, (2) measures to ensure separate supervision of personnel, (3) measures to ensure independence of remuneration, (4) structures to prevent or limit inappropriate influence, and (5) measures to prevent or control the simultaneous or sequential involvement of a person in separate investment or ancillary services or activities. However, in cases where these measures would not be appropriate or sufficient, firms are allowed to apply additional or alternative measures.[205] Such separation in particular will have to be applied between the activities of portfolio management and proprietary trading and corporate finance.[206]

79. Separation of activities by internal procedures within one financial firm is known as a Chinese Wall. Such a mechanism should be distinguished from a firewall, as was im-

---

[199] ESC/18/2005 (note 198), Annex, p. 6.

[200] Article 20, ESC/17/2005-Rev3 (note 195).

[201] Article 13(10), MiFID.

[202] Article 21(3), ESC/17/2005-Rev3 (note 195).

[203] *See* ESC/18/2005 (note 198), p. 5.

[204] Article 21(4), ESC/17/2005-Rev3 (note 195).

[205] Article 21(5), ESC/17/2005-Rev3 (note 195); *see also* ESC/18/2005 (note 198), p. 5.

[206] *See* recital 9 the Commission proposes to insert in the preamble to the Level 2 implementing regulation, ESC/17/2005-Rev3 (note 195), p. 1-2.

posed between commercial and investment banking in the thirties. While a firewall is primarily intended to protect an institution providing one financial activity against the risks inherent in – and the potential financial problems for the firm caused by – another financial activity (*i.e.* keep the "fire" started in one department from spreading to other departments or addressing the contagion problem within financial institutions),[207] a Chinese Wall is intended to avoid the free flow of information within a firm.[208] This practice was originally developed for purposes relating to potential criminal liability for insider trading, not only as a prophylactic method to avoid inside information available in one division in the financial institution to be used as the basis for transactions undertaken by other departments within the institution, but also as an attempt of the institution to defend itself against claims from clients based on an alleged use of privileged information or the fact that the institution did not act based on certain information even though it did have this information at its disposal.[209]

80. Although such barriers and procedures have become a standard part of the mechanisms applied in order to manage conflicts of interest in financial institutions, their contribution to alleviating these problems is modest. One of the reasons is that while Chinese Walls might be able to restrict the flow of information,[210] and recent regulations broaden their grip by also including measures to sever direct lines of reporting, supervision, influence and remuneration, they do not as such avoid the existence of conflicts of interest.[211] Moreover, they are not really a method to influence the loyalty of the personnel involved.[212] Chinese Walls might be effective in avoiding that an institution uses one client's privileged information against the interests of that client to

---

[207] *See* P. GRAHAM, "The Statutory Regulation of Financial Services in the United Kingdom and the Development of Chinese Walls in Managing Conflicts of Interest", in E. MCKENDRICK (ed.), *Commercial Aspects of Trusts and Fiduciary Obligations*, Oxford: Clarendon Press, 1992, 43-53, p. 49; R. CRANSTON (note 67), p. 104-105.

[208] *Cf.* H. MCVEA (note 54), p. 123 and 126; G. MCCORMACK (note 54), p. 30; N.S. POSER (note 54), p. 119.

[209] *See* H. MCVEA (note 54), p. 124-125; N.S. POSER (note 54), p. 119 and 159-163; *see also* N.S. POSER (note 124).

[210] And there is even legitimate doubt whether Chinese Walls are effectively leak proof. *See e.g.* A. LEHAR & O. RANDL, "Chinese Walls in German Banks", June 2003, available in the Social Sciences Research Network electronic library, <www.ssrn.com/abstract=424010>.

[211] *See also* the U.K. Department of Trade and Industry (DTI) White Paper *Financial Services in the United Kingdom: A New Framework for Investor Protection*, Cmnd. 9432, January 1985, p. 19-20: "The Government are not convinced that total reliance can be placed on Chinese walls because they restrict flows of information and not the conflicts of interest themselves", quoted in P. GRAHAM (note 207), p. 50; B. RIDER (note 123), p. 163: "The courts have shown no great enthusiasm for Chinese Walls and similar devices which, while they may serve to inhibit or at least control the flow of information within a multiplefunction fiduciary, do not address the inherent conflict of interest."; *see also* N.S. POSER (note 54), p. 166; *see also* N.S. POSER (note 124), p. 112.

[212] *See also* P. FINN (note 121), p. 26 (1992): "Whatever efficacy 'walls' etc. might have as information protection devices, segregation is not a loyalty-engendering contrivance"; H. MCVEA (note 54), p. 223: "Chinese Walls are useful defense measures for conglomerates to protect themselves from liability in certain circumstances, but should not be relied upon as a means of discharging duties owed." Moreover, recent research in behavioral economics has shown that self-serving behavior is not necessarily the result of a conscious choice by the actor, so that all too often a person is under the honest conviction that he has acted without taking his own interests into account while in fact his behavior turns out be significantly influenced by his own interests. *See e.g.* D.A. MOORE, P.E. TETLOCK, L. TANLU & M.H. BAZERMAN, "Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling", *Academy of Management Review* 31 (2006) forthcoming in nr. 1, Harvard Business School Working Paper No. 03115; Harvard Pon Working Paper; CMU Tepper Working Paper, available in the Social Sciences Research Network electronic library, <www.ssrn.com/abstract=667363>; *see also* M.H. BAZERMAN, G. LOEWENSTEIN & D.A. MOORE, "Why Good Accountants Do Bad Audits", *Harvard Business Review* 80 (2002/1) 87-102.

further the interests of another client or itself, but these cases only represent a very small fraction of the conflicts problems financial institutions face. The information that is most often relevant for the transactions for investment clients usually cannot be kept private by Chinese Walls or other internal measures, as it usually is information that is publicly available. To give only one example: how could a Chinese Wall avoid that the asset management division of a firm knows that the investment banking division is underwriting certain securities offerings and thinks it is in the interest of the firm to help by placing these securities in controlled portfolios?[213] And last but not least, one can wonder whether a truly effective Chinese Wall would not in effect undo the advantages conglomeration can bring.[214]

3. Disclosure Requirements

81. Disclosure has been a standard tool in the kit of legal techniques to tackle conflicts of interest for a long time. Disclosure apparently is considered to be a more "flexible" legal instrument.[215] Perhaps more importantly, disclosure is a much less intrusive remedy, compared to alternative regulatory interventions such as prohibitions of certain actions or mandatory segregation of specific activities.[216] As such, disclosure can be characterized as involving a "minimal disruption of the status quo".[217] However, given the fact that disclosure in the modern financial world has become a very costly activity, it would be worthwhile to verify whether existing disclosure requirements supposedly handling conflicts of interest actually are an effective and efficient way of tackling the problem.

82. The first way that disclosure can help is by providing the principal, in this case the client, with information relating to the way the agent, in this case the portfolio manager, performed his functions *ex post*. Such information is supposed to enable the principal to take effective legal action against an agent that breaches his duties.[218] However, re-

---

[213] *See also* L. ENRIQUES (note 3), p. 12-13.

[214] It is argued that the economic advantages of conglomeration are mainly realized in information gathering activities. *See* L. VAN DEN BERGHE & K. VERWEIRE, *Creating the Future with All Finance and Financial Conglomeration*, Dordrecht: Kluwer, 1998, p. 56-57. However, it is precisely the sharing of information which a Chinese Wall should inhibit. *See* H. MCVEA (note 54), p. 128-129, 205-206 and 225-227; *cf.* N.S. POSER (note 54), p. 205; N.S. POSER (note 124), p. 115: "Chinese walls tend to defeat the business reasons for creating multiservice firms."

[215] K.J. HOPT (note 56), p. 67.

[216] *Cf.* J. SUROWIECKI, "The Financial Page: The Talking Cure", *The New Yorker Magazine*, 9 December 2002, p. 54: "It has become a truism on Wall Street that conflicts of interest are unavoidable. In fact, most of them only seem so, because avoiding them makes it harder to get rich. That's why full disclosure is suddenly so popular; it requires no substantive change. […] Transparency is well and good, but accuracy and objectivity are even better. Wall Street doesn't have to keep confessing its sins. It just has to stop committing them."

[217] D.M. CAIN, G. LOEWENSTEIN & D.A. MOORE, "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest", *Journal of Legal Studies* 34 (2005) 1, p. 3; *see also* D.M. CAIN, G. LOEWENSTEIN & D.A. MOORE, "Coming Clean but Playing Dirtier: The Shortcomings of Disclosure as a Solution to Conflicts of Interest", in D.A. MOORE, D.M. CAIN, G. LOEWENSTEIN & M.H. BAZERMAN (eds.), *Conflicts of Interest. Challenges and Solutions in Business, Law, Medicine, and Public Policy*, New York: Cambridge University Press, 2005, 104-125, p. 107-108.

[218] K.J. HOPT (note 56), p. 68.

quiring an asset manager to *ex post* disclose facts that might have implied a conflict of interest does not necessarily provide the investor with a legal remedy, as the fact that a conflict existed does not imply a breach of duty under standard continental civil law in general and European regulation of asset management in particular. In addition, the investor would be required to prove that the asset manager was not only confronted with conflicting interests but also that he based certain investment decisions on these inappropriate interests, which in practice is very difficult.[219] For this purpose, therefore, this type of *ex post* disclosure will not help as long as the material law applicable to asset management is not modified.

83. Secondly, disclosure can be relevant in relation to fiduciary duties. As a general principle of fiduciary law, a fiduciary confronted with a conflict of interest must either fully inform the beneficiary of the existing conflict and its potential consequences and obtain his informed consent, or abstain from acting for the account of the beneficiary. The origin of this rule, often referred to as "disclose or abstain", can be linked to the principle that does not allow any secret profits for the fiduciary.[220] However, it can also be seen as a method to eliminate the conflict of interest. If the beneficiary is fully informed and decides himself whether to consent to the transaction or not, the arbitrage between the conflicting interests is not performed unilaterally by the fiduciary but is the result of arm's length negotiation between two parties. Disclosure effectively relieves the fiduciary of his duty of loyalty for that specific transaction, as it is the beneficiary himself that will further his own interests in the matter. As the fiduciary is no longer acting "*en fonction fiduciaire*" as it were, the law switches from "fiduciary mode" to "contract mode",[221] so that no fiduciary duties are applicable.[222] Disclosure, therefore, is not only an answer that fiduciary law gives to conflicts of interest, but also provides a way out of the reign of fiduciary law.

More generally, irrespective of whether a legal system contains fiduciary duties accompanied by equitable remedies or not, *ex ante* disclosure of conflicts of interest makes it theoretically possible for the principal to reappraise the situation and to decide whether he wants to maintain the delegation of power to the agent or not.[223] Choosing to end or temporarily suspend the delegation of power based on a disclosed conflict in effect relieves the agent from his duty of loyalty, so the conflict of interest disappears.

---

[219] *See supra* paragraph 50.

[220] *See* L.S. SEALY, "Some Principles of Fiduciary Obligation", *Cambridge L. J.* (1963) 119, p. 135.

[221] *See* T. FRANKEL (note 14), p. 131; K.B. DAVIS, Jr. (note 17), p. 47: "By fully disclosing her interest in the transaction, [the fiduciary] becomes free to deal with the principal because the principal's independent judgment is presumably now triggered as a safeguard against the fiduciary's opportunism".

[222] For historical notes as to the development of the disclosure duties in fiduciary law, *see* L.S. SEALY (note 220), p. 125-126.

[223] K.J. HOPT (note 56), p. 68. *See also* M. DAVIS (note 5), p. 13: "Disclosure […] prevents deception and gives those relying on P's judgment the opportunity to give informed consent to the conflict of interest, to replace P instead of continuing to rely on him, or to adjust reliance in some less radical way (*e.g.*, by seeking a 'second opinion') or by redefining the relationship (*e.g.*, by requiring recusal for a certain range of decisions)."

84. In the context of asset management, this can only work if separate disclosure is required for every investment decision in the performance of the portfolio management that poses a conflict. If only general *ex ante* disclosure is required, that information will not allow the principal to take the relevant investment decisions himself. It will also not allow the principals to distinguish "good" type asset managers from "bad" type portfolio managers, as that kind of disclosure will show all asset managers that are part of a multifunctional financial institution to be confronted with similar kinds of conflicts of interest and will not reveal which of these institutions will abuse such conflicts and which will not.[224] Such a general disclosure requirement will not avoid, it will on the contrary result in the so-called lemons problem AKERLOF was pointing out:[225] it will reduce the confidence of the investors in the average quality of the services offered by asset managers, and as a result they will invest less than they would ideally want. General *ex ante* disclosure, therefore, might protect the interests of investors in the sense that it can allow them to negotiate an across the board *ex ante* compensation for the general or average risk of abuse of conflicts of interest, but as discussed above, this is not the most compelling rationale for the law to specifically tackle conflicts of interest problems.[226]

85. And unfortunately there are more problems. Disclosure is usually defended as an appropriate remedy because it supposedly reduces the information gap or asymmetry between informed financial professionals and uninformed, unsophisticated investors.[227] The effectiveness of this remedy is based on the assumption that disclosure will allow the thus informed principals to properly discount the value of the agent's performance and, therefore, defend their own interests by in effect using less of the agent's services or paying less for these services. This, in turn, will provide the proper incentives for the agent to adapt his behavior to the preferences of the informed principals.[228]

However, recent research suggests that disclosure of conflicts of interest might not only not have this intended effect, it might in many instances even have unintended perverse effects, increasing rather than reducing the inefficiencies conflicts of interest create. This stems from the fact that in most situations principals are not able to sufficiently discount the actions of the agent, while the disclosure paradoxically often will lead to more self-serving behavior by the agent, as he tries to compensate for the

---

[224] This kind of disclosure is not the type that can be the basis for reputations to develop, allowing customers to distinguish "good" from "bad" type service providers. *See supra* footnote 44.

[225] *See supra* paragraph 17.

[226] *See supra* paragraph 18 and Section III.C.3.

[227] *See e.g.* P.M. HEALY & K.G. PALEPU, "Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature", *Journal of Accounting and Economics* 31 (2001) 405, p. 412.

[228] About effectiveness of disclosure in general, *see* A. FUNG, D. WEIL, M. GRAHAM & E. FAGOTTO, "The Political Economy of Transparency: What Makes Disclosure Policies Effective?", Ash Institute for Democratic Governance and Innovation, John F. Kennedy School of Management, Harvard University, Working Paper OP-03-04, 2004, available in the Social Sciences Research Network electronic library, <www.ssrn.com/abstract=766287>.

reduced confidence of the principals but also feeling less inhibited by ethical considerations.[229]

86. For students of security regulation this might come as a surprise, given the overall reliance of such regulation on the concept of disclosure as a mechanism of investor protection.[230] Surely, nobody would dare to question the wisdom of that approach. The explanation must partially be sought in the distinction between the investor protection dimension, which indeed in many instances will demand disclosure requirements, and the conflict of interest dimension, which does not necessarily. The root cause of the problem lies in the characteristics of the duty of loyalty.[231] Here, disclosure can only be a remedy in the sense that disclosing a conflict of interest will allow the principal to take his interests back into his own hands and thus relieve the agent of the duty of loyalty in respect of the specific transaction the disclosure is about, in effect dissolving the conflict of interest. But this is a fundamentally different mechanism from using disclosure as a means to allow the principal to discount the actions of the agent so that the market mechanism can take care of the problem. Such discounting is just not very feasible in the case of conflicts of interest.[232]

87. The MiFID, interestingly, does not require an asset manager to disclose *all* conflicts of interest it will be confronted with. According to the Level 1 text, disclosure is only required in cases where "organizational or administrative arrangements made by the investment firm […] to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented".[233] In other words, if the firm anticipates a conflict not to damage the client's interests because the way the firm manages that conflict is considered to be appropriate, specific dis-

---

[229] *See* D.M. CAIN, G. LOEWENSTEIN & D.A. MOORE, "The Dirt on Coming Clean" (note 217), p. 4-8; IBID., "Coming Clean but Playing Dirtier" (note 217), p. 108-119.

[230] *Cf.* F. EASTERBROOK & D. FISCHEL, "Mandatory Disclosure and the Protection of Investors", *Virginia Law Review* 70 (1984) 669, p. 670: "The dominating principle of securities regulation is that anyone willing to disclose the right things can sell or buy whatever he wants at whatever price the market will sustain." *See also* P. MAHONEY, "Mandatory Disclosure as a Solution to Agency Problems", *University of Chicago Law Review* 62 (1995) 1047-1112.

[231] *See supra* paragraphs 7-9.

[232] *Cf.* D.T. MILLER, "Psychologically Naive Assumptions about the Perils of Conflicts of Interest", in D.A. MOORE, D.M. CAIN, G. LOEWENSTEIN & M.H. BAZERMAN (eds.), *Conflicts of Interest. Challenges and Solutions in Business, Law, Medicine, and Public Policy*, New York: Cambridge University Press, 2005, 126-129, p. 127, distinguishing between two types of discounting, discounting involving recalibration on the one hand, and discounting involving diagnosing the motives that underlie the acts of the agent on the other. While the first type of discounting is prohibitively difficult, the second type of discounting would simply lead to dismissing the services of the conflicted agent out of hand. It is this second type of discounting that disclosure in the case of conflicts of interests was intended to produce, much like disclosure functions within fiduciary law, and not the first kind of discounting, which would be the intended result of the kind of disclosure imposed as a method of consumer or investor protection in general.

[233] Article 18(2), MiFID. In its earlier consultations in the process of drafting the revisions of the ISD, the Commission took a stricter line that would have required firms to abstain from any action when they are confronted with a conflict of interest if their organization would not prevent any risk of prejudice for the clients. It is apparently only after heavy lobbying on this point that the ultimate rule allows investment firms to act even when confronted with a conflict of interest even if their organization does not fully protect the interests of the clients if they at least disclose the existence of the conflict. *See* J. HERBST (note 148), p. 215-216.

closure of a conflict of interest is not mandated.[234] In that case, the customer will have to do with the *ex ante* general disclosure of the investment firm's conflict of interest policy, namely the measures it has taken in general to manage the conflicts of interest its different activities pose.[235]

88. Moreover, the Commission recently considered to propose to limit the transaction specific disclosure required under Article 18(2), MiFID, to retail investors.[236] However, while Article 19(10), MiFID, which gives the Commission the regulatory power to adopt implementation measures for the general information duties of Article 19(3), MiFID, requires those implementing measures to take into account "the retail or professional nature of the client or potential clients", Article 18(3), MiFID, which instructs the Commission to adopt implementation measures for the conflict of interest rules in Article 18, MiFID, does not contain any such mandate, it does not even mention the distinction between different types of clients. We therefore fail to see on what legal basis the Commission would have the jurisdiction to substantially reduce the normative content of Article 18(2), MiFID, as applied to the relationship between investment firms and professional clients, to a mere duty to respond to a request from the client for information.[237]

89. But more importantly, limiting the disclosure requirement of Article 18(2), MiFID, to retail clients is not appropriate to tackle the problems posed by conflicts of interest. As regulation relating to conflicts of interest is linked to information asymmetries, it may seem logical to differentiate between wholesale or professional and retail domains.[238] But conflict of interest problems are just as prevalent in the relations with professional clients, and the fact that such clients are more likely to know when conflicts are present does not mean they no longer can legitimately expect loyalty from their asset managers.[239] As was already stressed earlier,[240] the agency problems created

---

[234] *See also* L. ENRIQUES (note 3), p. 6: "[T]he disclosure obligation is conditional upon the firm's judgment that the organizational and administrative arrangements in place cannot ensure the prevention of damage to clients. A bona fide judgment that those arrangements can prevent such risks, in turn, will imply no violation of the disclosure requirement, even if it turns out ex post that a client's interests actually have been damaged."

[235] *See supra* paragraph 74.

[236] While the first two working versions of the Commission did not contain a distinction based on the type of client, the third draft limited the implementation provision for Article 18(2) to disclosures to retail clients (*see* Article 23, EUROPEAN COMMISSION, INTERNAL MARKET AND SERVICES DG, *Organisational Requirements and Identification, Management and Disclosure of Conflicts of Interest by Investment Firms*, Working Document ESC/17/2005-Rev2, 9 September 2005, p. 20). The most recent, fourth draft, specifies that "An investment firm shall provide the information [required by Article 18(2), MiFID] to professional clients upon request." *See* Article 23(2), ESC/17/2005-Rev3 (note 195).

[237] *Cf.* the remark by CESR as a response to some respondents: "the disclosure obligations under Article 18(2) cover all categories of clients". *CESR's Technical Advice on Level 2 Implementing Measures on the First Set of Mandates. Markets in Financial Instruments Directive. Feedback Statement*, CESR/05-025, January 2005, p. 23 and 25.

[238] *See e.g.* I. WALTER (note 38), p. 184.

[239] Given the familiarity with the distinction between retail and professional clients as a concept to delineate specific protection offered by securities regulation, it may seem "normal" to limit the conflicts disclosure obligations to retail clients. However, to show how inappropriate this assumption is, one can ask how one would react if we were to propose that in the future law firms or attorneys would no longer spontaneously have to inform their professional clients of the conflicts of interest they are confronted with in representing them; only professional clients that ask, would have to be answered. We cannot imagine that such a rule change would be accepted based

by conflicts of interest are not the result of an unequal bargaining position of the parties at the time of transacting, which would suggest that the problem does not exist for professional clients. These problems are instead the result of a vulnerability of the client for disloyal behavior imbedded in the essential characteristics of the duty of loyalty *resulting from* the asset management agreement, and these characteristics[241] are as serious in contracts with professional clients as they are in contracts with retail clients.

90. Whether disclosure by itself is enough or the informed client also has to consent before the firm can provide or continue to provide the service or services or execute the transaction in relation to which that conflict arises, is still unclear. CESR advised requiring the client's consent, and in its first working version, the Commission had followed this advice.[242] However, in the second version of the Commission's draft for a Level 2 text[243] and in the subsequent versions,[244] this paragraph has been dropped, without indicating why. This is a bit strange, as this version still requires the disclosure "to enable the client to take an informed decision with respect to the investment or ancillary service in the context of which the conflict of interest arises."[245] Could it be that the Commission is only thinking of one-off transactions where the disclosure of the conflict prior to the client asking for the service can be assumed to imply his consent? Because applied to financial services such as asset management, this provision becomes problematic: shouldn't conflicts of interest that relate to potential individual investment decisions a portfolio manager can take in the performance of his asset management contract be disclosed? Can such disclosure be enough, even if it is not followed by any action by the client that can be understood to imply his informed consent?

91. As such, the disclosure requirement of Article 18(2), MiFID, might in practice more likely lead to a general system of disclaimers issued by investment firms,[246] instead of the type of disclosure that would be required to effectively resolve conflicts of interest. While disclosure is presented as a method to avoid conflicts of interest from creating problems for agents under a duty of loyalty, what this disclosure requirement in fact

---

on arguments that professional clients are presumed to fend for themselves and ask for this information if they consider it to be relevant.

[240] *See supra* paragraph 39.

[241] For these characteristics, *see supra* paragraphs 7-9.

[242] Article 23(2), EUROPEAN COMMISSION, INTERNAL MARKET AND SERVICES DG, *Organisational Requirements and Identification, Management and Disclosure of Conflicts of Interest by Investment Firms*, Working Document ESC/17/2005, 13 May 2005, p. 17. CESR's advice contained the same: Paragraph 11(b), CESR/05-024c (note 151), p. 44 and 42.

[243] *See* EUROPEAN COMMISSION, INTERNAL MARKET AND SERVICES DG, *Organisational Requirements and Identification, Management and Disclosure of Conflicts of Interest by Investment Firms*, Working Document ESC/17/2005-Rev1, 20 June 2005, p. 19.

[244] For the most recent version, *see* ESC/17/2005-Rev3 (note 195), p. 18.

[245] Article 23(1)(b), ESC/17/2005-Rev3 (note 195), p. 18; *see also* J. KROL (Administrateur, Commission Européenne, Direction Marché Intérieur), "Présentation générale de la directive MIF et de sa mise en œuvre", *Banque & Droit* 102 (July-August 2005) 4, p. 6: "le client doit être informé de la source et la nature des conflits pour qu'il puisse prendre une décision en toute connaissance de cause."

[246] *Cf.* K. VUILLEMIN (note 94), p. 590.

risks to do is to materially change the duty the investment firm owes the client. Indeed, there is a serious risk that the investment firm through disclosure will try to reduce the expectations of its clients,[247] which then can be used as an argument to limit its liabilities to those under a general duty to act with care, not a duty of loyalty.[248] In that way, unfortunately, the regulation might end up throwing away the baby with the bath water. While the problem of potentially unfulfilled expectations of investors might be avoided, the potential of realizing the higher level of efficiency when the asset management truly would act based on the exclusive interests of the investor is lost. Were conflicts of interest a mere investor protection issue, this consequence would be acceptable; however, as the main risks from conflicts of interest are to market efficiency, this result unfortunately fails to solve this problem.

V. Some Concluding Remarks

92. Asset management traditionally involved the portfolio manager explicitly or implicitly promising the client to loyally serve his investment interests. Such a duty of loyalty inherently creates conflicts of interest when the asset manager has personal interests that are touched by the investment decisions he has to take for the account of his clients or has several clients whose interests might come into conflict. Multifunctional financial institutions offering asset management services are very often confronted with such circumstances.

As it stands, European regulation does not adequately address the problems created by conflicts of interest for a number of reasons.

93. Both existing and considered rules do not contain realistic remedy provisions that take into account the essential characteristics of the conflict of interest problem, characteristics that make it impossible for the market mechanism to solve it if governed by standard private law. This is because of the inherent difficulties proving what actually motivated an asset manager who necessarily is mandated to act within a range of discretion and/or what the actual gains have been he personally realized through his actions.

Application of enforcement mechanisms such as those provided by common law fiduciary duties could solve this problem, but would require massaging to be realistic in

---

[247] How else should one interpret the boilerplate conflicts disclosure reportedly used by Charles Schwab & Co.: "Schwab and/or its employees or directors as well as consultants to Schwab may have had clients with positions in securities or companies referenced in Information, including Research Reports, and may, as principal or agent, buy from or sell to customers. From time to time, Schwab may perform investment banking or other services for, or solicit such services from, companies mentioned in Information." D.M. CAIN, G. LOEWENSTEIN & D.A. MOORE, "Coming Clean but Playing Dirtier" (note 217), p. 111.

[248] *See* N.S. POSER (note 124), p. 122-123, summing up the usual disclaimers in the common agreements with investment-management clients, concluding that "[t]hese kinds of clauses may have the effect of avoiding a firm's liability for failing to meet fiduciary duties owed to its clients." *See also* D.M. CAIN, G. LOEWENSTEIN & D.A. MOORE, "The Dirt on Coming Clean" (note 217), p. 3, comparing this with the result of the warning labels on cigarette packages: a requirement that was intended to protect consumers in fact ended up shielding tobacco producers from liability for damages suffered by smokers that were warned. In other words: "*Caveat emptor*!"

their application to institutional asset management. Thus far, however, both the Level 1 text of the MiFID and the draft text circulating for the proposals of Level 2 implementation regulations fail to properly specify the general duty of loyalty as it should be applied to asset management services so as to avoid the enforcement problems of a general duty of loyalty.

94. Another problem is that the European legislator and regulator seem to start from a mere investor protection rather than a global market efficiency rationale in designing conflict of interest rules. This is misguided because even when the market mechanism can in many instances succeed in sufficiently protecting the investors against abuses from financial institutions, the market as such will most likely not reach a socially optimal equilibrium.

As a practical matter, this unfortunate focus on investor protection results in an unwarranted distinction between professional and retail clients with respect to conflict of interest rules. Both types of clients should be able to rely on the loyalty of their asset manager(s) and the agency problem that in effect undermines this confidence and thus limits market efficiency is a consequence of inherent characteristics of an asset management contract, not a result of the lack of sophistication of certain investors.

95. Finally, the considered rules also overly rely on disclosure to solve problems it cannot solve. Disclosure is generally accepted to be an efficient measure when trying to address asymmetric information problems existing at the time of contracting or taking investment decisions. However, in conflict of interest situations the function of disclosure is not so much to redress an informational asymmetry at the time of contracting, as the informational asymmetry that must be addressed reappears at every single investment decision to be taken by the asset manager.

Hence, to solve the conflict of interest problem, disclosure will only work if it effectively acts to end the delegation of power to the agent and allow the principal to take the decision himself, or at least to force the agent to disclose all gains he will realize and has realized from acting with the conflict to enable both *ex ante* and *ex post* negotiation between agent and principal to allow market forces to allocate these gains between principals and agents. This kind of disclosure would seem to undermine the basic reason that investors use institutional asset managers – namely to have them take the investment decisions on their behalf without bothering them – and hence it is not surprising that the disclosure measures contemplated in MiFID are geared at the time of contracting. The problem is that this means the required disclosure most likely will not be effective against the conflicts of interest problem faced by institutional asset managers.

96. As long as returns on investment are satisfactory or in line with expectations, investors will not complain about conflicts of interest present in the asset management sector, but when the market takes a turn as it has at the beginning of this decade, financial institutions risk being burdened with complaints and law suits by investors trying to recover part of their losses. Abuses of conflicts of interest might be difficult to

prove by an investor, but at the same time an accusation of such an abuse is almost impossible to disprove, resulting in a legal risk for the financial institutions. Also, the potentially resulting loss of confidence of small investors is undesirable for the service providers and for the market.

Interestingly, the asset management sector recently has shown three developments that could partially be explained as a reaction to the general problem of conflicts of interest.

97. First, the industry has been moving away from the traditional single asset manager that controls a broad based portfolio towards very specialized mandates focused on narrowly defined asset classes and clearly defined investment styles and strategies.[249] Performance is being evaluated based on general or specialized market indices or, if none are available for the investment category involved, peer group benchmarks are employed.[250] Such contractual arrangements make it more difficult for asset managers to deliberately hurt the client's interests by choosing suboptimal investment decisions without being caught. Given competition forces, these developments allow the market mechanism to reduce the conflicts of interest problem to a level that stays below the radar, *i.e.* a level at which no *ex post* verifiable bias can be measured.

Second, most asset management contracts include disclaimers trying to limit the potential liability of the financial firm.[251] Not only are such clauses designed to inform the client in advance of any potential conflict of interest thereby shielding the firm from any future claim based on such a conflict, but they also in effect aim to limit the duties the portfolio manager owes his client. Under the most broad of such exonerating clauses, the asset manager only promises to spend a reasonable amount of effort trying to generate an investment result that conforms with the industry standards, without being required to take the best decision for the investment interests of the client at every turn. In other words, the asset managers try to substitute a traditional duty to act with care for the potentially problematic duty of loyalty, as a result avoiding the problem of conflicts of interest all together.

While these two evolutions could prove helpful in limiting the potential liability for asset managers and thus could restrict their legal risk, they do not help solve the most essential problem created by conflicts of interest – reduced market efficiency. The reduced confidence of the investors in the financial institutions or the limited expectations clients have of what their professional service providers in fact have to offer, will result in a market equilibrium at a lower level than optimal. In other words: investors

---

[249] Apart from obviously being included in the agreement between the firm and the client, the Level 2 regulations contemplated by the Commission will require the portfolio manager also to provide a retail client with a summary of the types of financial instruments that may be included in the client portfolio and types of transactions that may be carried out in such instruments, including any limits, the management objectives, the level of risk to be reflected in the manager's exercise of discretion, and any specific constraints on that discretion. *See* Article 5(3), ESC/23/2005-Rev2 (note 149).

[250] *See* BANK FOR INTERNATIONAL SETTLEMENTS (note 22), p. 19; if a benchmark is being used, the retail client has to be informed. *See* Article 5(2)(c), ESC/23/2005-Rev2 (note 149).

[251] *See supra* footnotes 246-248 and accompanying text.

might very well use less asset management services and hence keep a smaller proportion of their savings in risk bearing assets than would be optimal for the economy.

98. Remarkably, one can see a move in the practice of multifunctional financial institutions to voluntarily segregate activities more than the regulation requires. The move from closed- to open-architecture in the distribution of collective investment schemes is an example, but even more typical is the fact that several larger financial firms have brought all their asset management activities – both individual portfolio management and the management of collective investment schemes such as UCITS – into a separate subsidiary of the financial institution or separate corporation within the conglomerate, with no other activities.[252] Although clearly inspired by a desire to realize more economies of scale, this structure can also be seen as a way of complying with the level of separation of activities required by the regulation.

However, while separate legal personality, combined with liability limited to the assets of each corporation, is an effective mechanism to create a firewall designed to insulate each activity center from the financial distress existing in another center, it does not sever lines of loyalty. As corporate careers of personnel often involve hopping from one conglomerate entity to another, loyalty can attach to the conglomerate group as a whole, ignoring the specifics of the corporate structure of the companies constituting the group.[253] For loyalty to be restricted to the asset management activity alone, it might very well be necessary to completely sever the links between the asset management corporation and the rest of the financial group, attracting other shareholders for the asset management company.

And interestingly, there seem to be initiatives in the market to do precisely that.[254] This can bring marketing advantages on the buy side of the market, as the separation and thus independence can be highlighted as a strength. In effect, this is a method for the asset managers to signal to potential clients that they are truly independent of the sell-side of the market and therefore not subject to the conflicts of interest combining these activities would bring, which allows them to avoid a so-called lemons' discount.[255]

---

[252] The combination of both individual and collective portfolio management within one company was made possible since the 2001 amendments of the UCITS Directive. *See* Article 5(3), UCITS Directive, as amended by Directive 2001/107/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the Coordination of Laws, Regulations and Administrative Provisions relating to Undertakings for Collective Investment in Transferable Securities (UCITS) with a View to Regulating Management Companies and Simplified Prospectuses, *Official Journal*, L 41, 13 February 2002, p. 20.

[253] In this regard, the findings of P. SPINNLER, L. PROBST & C. SOGUEL ("Conflict of Interest in Fund Distribution", elsewhere in this book) in relation to the factual business model in the European fund industry, specifically the fact that the personnel of the fund management companies in fact are delegated from the promoting financial institution, are interesting.

[254] *See* for instance the recent efforts of the Fortis Group to find a joint venture partner for its asset management business, in particular the reported talks between Fortis and Lloyds TSB bank to merge their respective asset management corporations. "Lloyds in Talks to Merge Widows Fund Arm", *The Independent*, 11 November 2005; T. BRAITHWAITE & L. SAIGOL, "Lloyds in Talks with Fortis on Asset Management Deal", *Financial Times*, 12 November 2005, p. 15.

[255] *See supra* footnote 80.

99. The ultimate question is whether such separation should be legally imposed. Today, most regulators clearly do not favor a mandatory separation as a method to tackle conflicts of interest problems.[256] As a justification for this position, CESR noted that it has not been shown that the benefits for clients resulting from disaggregation of large financial firms would outweigh the costs.[257] However, it would be interesting to investigate – also empirically – what real economic benefits are gained by combining buy side portfolio management with sell side activities or services in the same firm. Is combining these functions in one firm or one group of firms actually efficient from a social point of view or rather only from the individual point of view of the firm involved? If the only economic advantages that can be named are economies of scale or scope, do they actually outweigh the costs the inherent conflicts of interest cause, not in the least the compliance cost because of all special regulation that would not be necessary if these functions would be totally separate? And mainly, would segregation not ultimately allow the market to reach equilibrium at a higher level, as global confidence of investors in the loyalty of asset managers would grow?

In 2000, the SEC, fully aware of the problems of conflicts of interest in the auditing industry, considered but rejected a mandatory separation of audit and consulting services and chose only to impose disclosure as a remedy.[258] Less than two years and one particularly publicized and therefore politicized scandal later, the US legislator had changed its mind and imposed a ban on combining auditing with non-auditing services for the same client in the Sarbanes-Oxley Act.[259] Let's hope it does not take another scandal to convince the regulators that the control over the investments of savers (buy-side, asset management services) should better not be in the same hands as the control over the production and distribution of objects that can be invested in (sell-side services and market organizing or transaction execution services).

---

[256] This might be related to past experiences with the separation of commercial and investment banking. *See* for example E.N. WHITE (note 29), p. 296: "Perhaps, the most potent example of a misplaced remedy is the separation of commercial and investment banking by the Glass-Steagall Act. The separation imposed a high cost; and only after a long struggle, was the act was [*sic*] reversed in 1999. Market discipline that forced institutional changes on banks worked fairly well before 1929. The repeal of Glass-Steagall moved back to a greater emphasis on disclosure and oversight that were originally recommended by contemporary experts." We think that considering the Glass-Steagall Act to be a "misplaced" remedy is partially based on a mistaken confusion between the rationale for the separation of commercial and investment banking – mainly to avoid financial risks spreading from one activity into the other and thus tackled by imposing a firewall – and the rationale for the separation of asset management from other supply side financial services – mainly to avoid conflicts of interest. *See supra* paragraph 79. This, however, does not stand in the way of a conclusion that the regulatory separation of commercial and investment banking for a long time had the effect of creating structural barriers to some conflicts of interest, which very soon after the passage of the Gramm-Leach-Bliley Act (Public Law No. 106-102, 12 November 1999, 113 Stat. 1341), which in Section 101(a) repealed the Glass-Steagall Act (12 U.S.C. 377), became prominent. *See* I. WALTER (note 38), p. 175.

[257] *See* CESR/05-024c (note 151), p. 41; *see also* already *CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments, Consultation Paper*, CESR/04-261b, June 2004, p. 40. The actual formulation of CESR ("the costs associated with disaggregation cannot be shown to outweigh the benefits to clients.") seems to be a mistake.

[258] *See* SEC, Final Rule: Revision of the Commission's Auditor Independence Requirements, Release No. 33-7919, 21 November 2000, codified in 17 C.F.R. Parts 210 and 240.

[259] *See* Section 201 of the Sarbanes-Oxley Act, Pub.L. 107–204, 30 July 2002, codified as 15 U.S.C. 78j-1(g).

Ultimately, if one wants patients to trust a medical doctor only to prescribe medication based on purely medical considerations and not because the physician has an interest in doing so, the mandatory separation between doctors' practices and the distribution of medication through pharmacies seems to be a good idea. Why would it be fundamentally different for asset management?

Financial Law Institute

The **Financial Law Institute** is a research and teaching unit within the Law School of the University of Ghent, Belgium. The research activities undertaken within the Institute focus on various issues of company and financial law, including private and public law of banking, capital markets regulation, company law and corporate governance.

The **Working Paper Series**, launched in 1999, aims at promoting the dissemination of the research output of the Financial Law Institute's researchers to the broader academic community. The use and further distribution of the Working Papers is allowed for scientific purposes only. Working papers are published in their original language (Dutch, French, English or German) and are provisional.

© Financial Law Institute
Universiteit Gent, 2005

More information about the Financial Law Institute and a full list of working papers are available at:

http://www.law.UGent.be/fli