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# Conflicts of interest in the provision of investment services to retail clients. Costs and benefits analysis of the current European regulation.

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By

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**PUBLICATIONS AND PRESENTATIONS**

G. Gobbo (2009), The MiFID regulatory and supervisory architecture, in Casey, Lannoo *The MiFID Revolution*, Cambridge University Press, Chapter X.

G. Gobbo (2009) "MiFID's Systematic Internalisation: the Efficiency Debate and the Future of the European Financial Markets", *European Business Law Review*, 20:1.

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G. Gobbo (2007) "Servizi di investimento" – Enciclopedia giuridica – Il Sole 24Ore.

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G. Gobbo, C.E. Salodini (2006) "La giurisprudenza in materia di servizi di investimento", *Giurisprudenza commerciale*, II, 5.

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# Abstract.

The thesis focuses on the problem of conflicts of interest's exploitation between investment firms and their retail clients in the provision of investment services in light of the new European rules of the Markets in Financial Instruments Directive (Directive 2004/39/EC) and its level-2 measures (Commission Directive 2006/73/EC and Commission Regulation 1287/2006) – collectively, 'MiFID' – as interpreted by CESR's recommendations. I analyse MiFID from a cost-efficient point of view, and seek to answer the question whether such regulation addresses the problem identified in a way that the costs it entails are offset by its benefits, where the same benefits cannot be otherwise achieved at a lower cost.

Intuitively, from the point of view of investors, the more rights they are granted, the 'better' the regulation is; nevertheless, the same cannot be held from a cost-efficient point of view. A regulation which accords overprotection to some investors does not add anything to their protection, while clearly adding to the intermediaries' costs of compliance, which firms might well spill onto investors. Moreover, overprotection in the field of investment services adds to the costs from another point of view: since it risks hampering the fast and smooth flow of resources for the financing of businesses, it might constrain the efficient allocation of economic resource.

I evaluate MiFID in light of the libertarian paternalistic approach to regulation, which can accommodate for the existence of different players on the market and for the biases and limits of the regulator as well. Under this approach the regulation should embed both libertarian and paternalistic components, and make them interact in a way that the rules are able to correct the mistakes of the biased players (minimise the costs of errors) while less than proportionally increasing the possibility that rational players are hindered from taking the right decisions (minimise the costs of the missed right decisions), net of the implementation costs.

I also read MiFID in light of the findings as to the best (value maximising) balance between rules and standards. The tightening of the provisions appears to be a normal development of any regulation: the more an area of law becomes established, and the more the volume of litigation increases, the more it is cost-efficient to bear the fixed cost of devising a detailed regulation. Nevertheless, if the rate of obsolescence of a regulation, the complexity of the legal environment and the cost of coordination of the new rules with the previous ones are high, the adoption of rules becomes too costly, as compared to its benefits.

I find that MiFID adopts a quite paternalistic approach, which leaves it in the hands of intermediaries to surrogate for investors' decisions. This is set as the default rule for a considerable vast number of investors, not all of which are likely to share the same need for protection. Where it features a more libertarian approach – and in particular where it aims at bringing investors' informed consent in the foreground – two failures can be detected. First, MiFID seems wary as to the 'type' of the clients on the market: it assumes the existence of, sometimes, rational – albeit asymmetrically informed – investors; sometimes, boundedly rational investors. Clearly, the same measure cannot serve both. Second, a close analysis of the detailed rules which aim at emphasising clients' consent shows that, in reality, investors are given little possibility to truly understand – and consent to – transactions. I also find that the regulation only limitedly leaves open the possibility to opt-out from the mandatory system, and to thereby compensate its failures.

This is not to say that MiFID does not mark a progress as compared to its forerunner, the Investment Services Directive, of which I also give account.

Financial markets are a lively and evolving environment, which currently present some distinctive trends: the increasing substitutability of products sold by intermediaries, and the spreading out of distance means of communication, above all. In light of these trends, I also verify whether MiFID, together with other pieces of regulation (mainly related to UCITS and insurance products), are adequate to protect clients against conflicts of interests exploitation. On this matter I find that, were it not for important national responses, some potentials for exploitation would be left 'uncovered' by the current interaction among different pieces of regulation.

Some works still need to be accomplished: the European regulation should increase the pace at which it gives response to the innovations related to the products and the marketing techniques: they are needed in order to ensure integrated markets which are safe and sound for investors who rely on intermediaries to circulate their resources.

## Conflicts of interest in the provision of investment services to retail clients. Costs and benefits analysis of the current European regulation.

**Introduction.**

The thesis focuses on the problem of conflicts of interest's exploitation between investment firms and their retail clients in the provision of investment services in light of the new European rules of the Markets in Financial Instruments Directive (Directive 2004/39/EC, MiFID) and its level-2 measures (Commission Directive 2006/73/EC and Commission Regulation 1287/2006) – collectively, 'MiFID' – as interpreted by CESR's recommendations.

I analyse MiFID from a cost-efficient point of view, and seek to answer the question whether such regulation addresses the problem of conflicts of interest exploitation in a way that the costs it entails are offset by its benefits, where the same benefits cannot be otherwise achieved at a lower cost. The cost-efficiency analysis can be conducted having regard to two aspects of the regulation: its overall approach and the techniques it deploys.

My analysis is guided by the findings of behavioural finance. This discipline has emphasised the biases which affect economic players, whose proper protection cannot only depend on the ability of the regulation to bridge information asymmetries.

I particularly benefit from the discussions on the libertarian paternalistic approach to the regulation. They posit that the regulation should embed both libertarian and paternalistic components, and that they shall interact in a way that the rules correct the mistakes that the biased players would do (minimise the costs of errors) while less than proportionally increasing the possibility that rational players are hindered from taking the right decisions they would otherwise take (minimise the costs of the missed right decisions), net of the implementation costs. A regulation achieving this aim is deemed to be cost-efficient.

This approach can accommodate for the existence of different players on the market and for the biases and limits of the regulator as well. Depending upon these variable, the libertarian and the paternalistic components shall vary.

The more players are not on the footing of taking correct decisions (or the more serious the costs of wrong decisions are), the more paternalistic the rules can be. Depending upon the players' biases which lead to such errors, the regulation can for example set default rules, mandate the provision of information, introduce advice duties, complete incomplete contracts.

The more rational players are on the market (or the more costly is would be to hinder correct decisions) the more the libertarian component can be emphasised. One possibility is that of choosing, among the paternalistic measures, those which leave open the possibility that players take decisions on their own. Rules allowing for parties to take decisions after they have been duly informed on the possibilities at disposal and their consequences are an example thereof. The other possibility is according the option to contract-out from the regulatory regime.

The libertarian component of the regulation shall also take the upper hand where the regulator risks not being able to perfectly appreciate the needs of the economic players or to give tailored responses thereto.

Implementation costs are also important. For any increasing level of clients protection, the regulation should also have regard to the costs imposed on intermediaries. From the investors' point of view, the more rights they are conferred – without that slowing down or hampering transactions –

the 'better' the regulation is; nevertheless, the same cannot be held from a cost-efficient point of view. A regulation which accords overprotection to some investors does not add anything to their protection, while clearly adding to the costs of compliance.

Reducing these costs should not be seen as the aim of a 'neat' regulator, but also as a true interest of the industry as well as of the investors. These latter are directly damaged insofar as the intermediaries: shift the costs on them by increasing the costs for the provision of the services; refuse to serve the marginal investor, i.e. the one which – despite obliging firms to comply with the full set of rules – offers limited revenues.

As to the regulatory techniques, the regulator can achieve its aims choosing between rules and standards, which can be combined in different ways.

By rules one should understand detailed provisions which punctually spell out what is required from players, and what their respective rights and duties are. On the contrary, the general clauses of fairness, professionalism, honesty are standards in that they identify the result of the interaction between players, but do not pre-determine the actions which are deemed to attain these results.

The way in which they interact can maximise the value of law. The tightening of the provisions appears to be a normal development of any regulation: the more an area of law becomes established, and the more the volume of litigation increases, the more it is cost-efficient to bear the fixed cost of devising a detailed regulation.

Nevertheless, if the rate of obsolescence of a regulation, the complexity of the legal environment and the cost of coordination of the new rules with the previous ones are high, the adoption of rules becomes too costly, as compared to its benefits.

One should also not neglect the correlation between rules and enforcement.

A cost-efficient regulation is also that which enacts, next to appropriate substantive provisions, provisions which ensure an effective and efficient enforcement. Otherwise, the enhanced protection (on the books) does not translate into a genuine increase of protection and, hence, does not lead to a wider confidence from the part of investors.

The correlation between rules and enforcement is a bidirectional one: on the one side, a credible enforcement is necessary to ensure compliance since it gives the incentives to internalise the negative externalities of an activity in a way which the regulator has deemed necessary and sufficient; on the other side, a detailed regulation (which spells out rights to individual parties) eases the bringing about of enforcement by parties. Therefore, despite enhancing the fixed costs of rule-making, rules can abate the variable costs (also in terms of the time needed to seek redress) of adjudication.

Nevertheless, rules are not always cheaper to adjudicate, since they trigger the cost of navigating though a complex web of legal requirements; if their rate of obsolescence is high, they also lead to decisions which do not properly address the needs of a changed business environment, and entail cases of over- or under-deterrence.

With these guidelines in mind, the work will show how – and to what extent – MiFID marks a clear progress as compared to its forerunner, while detecting some failures thereof: mainly, the excess of paternalism and proceduralisation of the rules, and the over-inclusiveness of the mandatory system. Thereby, it heightens the costs for firms and slows the accomplishment of transactions.

There are clear reasons for these choices. First, MiFID aims at compensating for the failures of its forerunner, the Investment Services Directive (ISD), whose lack of harmonisation was seen as a major obstacle to the promotion of cross-border businesses and the integration of the European financial markets.

After the ISD was enacted, a number of factors played a role in increasing the potential for cross-border activities. The introduction of the European Monetary Union and the common currency, decreased the impact of the exchange rate risk; innovations in technologies and financial products opened up for new investment possibilities; the number of retail investors facing the market increased. An heightened attention to clients was also needed in lights of some recent episodes of misselling which attracted the interest of the public opinion thought Europe. Hence, both pro-active response and anticipation of predictable future trends where at the heart of the decision to re-consider the regulatory framework.

Financial markets are a lively and evolving environment, which currently present some distinctive trends: the increasing substitutability of products sold by intermediaries to retail clients, and the spreading out of distance means of communication require, which require close attention in that they can create new opportunities for investors' exploitation. Therefore, the focus on investors protection requires to go beyond MiFID's regulation or, better, to verify how this directive interacts with other regulations (such as the UCITS, insurance companies and the marketing of life insurance, information technologies services and distance marketing directives) to ensure a safe and sound business environment.

The reasons why I addressed the issue of retail clients' protection against conflicts of interest exploitation are manifold. It is linked to one of the most recent trends in financial markets: the participation of retail clients to the market has outbroken in the last decades, and is deemed to increase to off-set the decreasing coverage these investors can obtain for their after-retirement needs from public pension schemes. The problem of conflicts of interest is crucial from this point of view since – the case of incompetent intermediaries apart – their exploitation lays at the very heart of all misbehaviours of the intermediaries.

MiFID is the first piece of regulation which has comprehensively addressed the problem. It can still be considered a recent piece of regulation (and its national implementations for sure are), on which relatively little has been written.

The thematic works issued so far are primarily focused on the comparison between MiFID's provisions and the national rules they replace. I aim at more extensively going through the whole framework of the directive to show at what costs, and with which benefits, it gives response to the problem of investors exploitation.

My research will extensively benefit from a number of works in the field of economics and the law: on the principal-agent relationship, on the incompleteness of contracts and their enforcement, on the rationale for regulation. I will also refer to empirical works (on IPOs and financial analysts) showing whether, and to what extent, intermediaries exploit conflicts of interest, and investors are likely to be fooled.

Where needed to understand some specific choices of the European regulator, I will consider other both supranational and national regulation. Some provisions allegedly enacted as a means of investors protection have their true rationale in the protection of the markets against manipulations. To appreciate this, and its consequences, I therefore refer to the Market Abuse Directive.

MiFID's choices will also be compared to those adopted in the US rules and in a number of Member States before MiFID. To show how MiFID is likely to concretely impact on the national markets to which it applies, I will make reference to recently-adjudicated cases and to regulations currently retained across the EU, with which the new framework has to interact. Such cross-sectional approach also represents a source of novelty as compared to other works on MiFID.

The thesis proceeds as follows: Chapter I lays the foundations of the study and spells out the tools deployed. It extensively draws from the economics literature to outline the problem of conflicts of interest exploitation, to define my understanding of cost-efficient regulation is and to identify the tools at disposal of the regulator. Chapter II enquires upon the benefits of MiFID as compared to its forerunner – the ISD – on the matter of clients protection against exploitation. Chapter III critically evaluates MiFID's two main regulatory pillars, organisation and information on the existence of conflicts, and their interaction; Chapter IV considers the conduct of business rules which help addressing the problem of exploitation, beyond what the two basic regulatory ideas allow for. To better understand the extent to which MiFID's rules give responses to the threats of intermediation, I will group the conduct of business rules around three types of exploitation which should be addressed. This choice is not imposed by the wording of MiFID, but is useful to better understand the concrete outcome of the complex web of rules. Chapter V spells out the services which create more concerns, and verifies whether MiFID's responses are commensurate to their threats. Chapter VI is devoted to the solutions at disposal when the costs of the regulation risk not being off-set by its benefits. I focus on the general clauses and the opt-out mechanisms to show whether, and to what extent, they are deployed by the new regulation and compensate for the formalism and paternalism. Chapter VII verifies the quality of enforcement under MIFID. It concentrates on private enforcement, public enforcement and the potentials for their interaction. Such interaction would in particular be desirable since it could allow for economies in the costly process of information gathering, it would help reduce the lengthiness of civil proceedings and would ease the position of the investors/claimants. Chapter VIII analyses MiFID and its interaction with other Directives to verify whether sufficient safeguards are in place to protect clients against exploitations in light of the most recent financial markets' trends: the substitutability of products and the use of means of distance marketing. Chapter IX summarises all the findings and concludes spelling out some debates which will probably take the upper hand in the near future.

# Chapter I

## Intermediation and the problem of conflicts of interest. A supranational regulatory concern.

### I.1. Financial Markets and their Role. The Recent Trends.

Financial markets are crucial in the functioning of the modern economies, in that they allow for the widest access to funding for economic activities and, contextually, to different surpluses' allocation possibilities for households. By bringing together supply and demand of investments, they facilitate resources allocation; by disseminating privately held information which is compounded in the value of the investments, they ensure that resources are allocated to their most efficient use[1]. This efficient allocation can be considered the steam-engine of economic growth. The economic literature unanimously holds that "financial development is associated with higher per capita income and a faster rate of economic growth"[2].

What said holds generally true, irrespectively to the market considered, its microstructure and the instruments traded thereon. There are common pre-requisites for this function to be performed. Liquidity, depth and volatility of the market, as well as safety, are some of them[3].

Liquidity is "a measure of the extent to which market participants can rapidly execute large-volume transactions with a small impact on prices"[4]. The more liquid the market, the easier it is to find a trading partner for each given trading intention, and the easier it is to execute efficient investment decisions. Liquidity impacts on the bid-ask spread, which is the difference between the highest price the buyer is willing to pay and the lowest price the seller requires. The smaller the spread, the closest the two values are, with the consequence that transactions are more easily accomplished[5].

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[1] I.e. in a way which maximises the net benefit obtainable through their use. Avgouleas (2005) pp. 23-24, offers a more detailed definition, stressing the four functions of markets for financial assets: to provide investors with a reliable criterion of value as to the value of investments; to ensure efficient allocation of scarce resources (investors' funds); to enable issuers to raise funds; to allow consumers and producers of physical commodities, as well as traders and users of financial assets "to acquire protection against adverse price movements".

[2] Tommasino (2006), p. 7; King, Levine (1993), Jayaratna, Strahan (1998), Rajan, Zingales (1998), Levine (2005). Directorate for Financial and Enterprise Affairs – Committee on Financial Markets - OECD (2008), p. 8.

[3] On this points, I will mainly draw from the work of Lee (2002), pp. 11 ff.

[4] Lee (2002), p. 12. Depth is closely related to liquidity, since it describes a market on which only large orders can impact determining a movement.

[5] The liquidity also creates a virtuous circle, since it attracts other liquidity thereby making the execution of order faster. Ferrarini, Recine (2006), pp. 238 ff.; Anolli, Bianchi, Venturino (2004), p. 14 ff.

Volatility, instead, is "a measure of the extent to which the prices of the assets traded in a market vary, both individually and collectively"[6]. A low volatility describes a market in which prices are relatively stable and investment decisions can be easily executed.

Markets' safety is also a crucial element, irrespectively to how one wants to correlate it to allocation efficiency. It can be linked to the concepts of integrity and fairness, as well as investors protection which, in *Lee*'s work, are two structural elements contributing to the market performance. Or, it can be seen as a pre-condition to high liquidity, high depth and low volatility.

Indeed, safety brings about confidence and only confident savers are willing to circulate their resources and thereby contribute to the supply-side of the market. The more players are on the market, the easier it is to find a trading partner; the more players and, hence, resources are on the market, the less easily orders below a large threshold impact on it, creating sudden shifts[7].

### *I.1.1. The markets and their microstructure.*

Next to the recognised exchanges, other markets have spontaneously developed over the years to offer investors different possibilities for trading: over-the-counter markets (OTC)[8], Multilateral Trading Facilities[9] (MTF) and internalised markets[10]. As compared to regulated markets, they offer a trade-off between quantity of regulation and, hence, protection, and breadth of trading possibilities. Although they were not regulated in the early stages of their development, the most recent trend is that toward an higher degree of convergence of the applicable rules. The aim is that of both preventing competitive disadvantage for some trading venues and ensuring that their multiplication does not trigger transactions' fragmentation, which would be detrimental to the overall liquidity of a given instrument and to the accuracy of the price formation

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[6] Lee, (2002), p. 12.

[7] Indeed, depth and liquidity are also a function of other circumstances, which pertain to the market structure, and contribute to the market efficiency in a way which confidence alone cannot provide for. These considerations nevertheless go beyond the scope of this work.

[8] OTC are a-subset of the Alternative Trading Systems (ATSs), trading platforms traditionally operated by non-exchange entities, whose importance has been rising in the Nineties as a consequence to the "advances in technologies and the advent of electronic trading" (FESCO (2000), 3). They have risen to allow for the exchange of securities which did not have the features required to be traded on an official market, and have allowed mainly for large trades by sophisticated agents.

[9] MTFs are a sub-set of the platforms previously known as ATSs and are ruled in the Markets in Financial Instruments Directive 2004/39/EC of 21 April 2004. These Facilities allow for the matching of participants' orders without the intervention of the system operator, which cannot match them against its proprietary positions, but merely interfaces users in a way which might result in the conclusion of contracts for exchanges.

[10] The term internalisation describes the practice by which investment firms (the internalisers) execute clients buy and sell orders on financial instruments by matching them with their own proprietary positions (Ferrarini, Recine, (2006), 3). Transactions are concluded outside a regulated market or a Multilateral Trading Facility and internally to the firm, which becomes a new trading venue. Some scholars also talk about internalisation when the order of a client is matched against one of another client. They treat the two cases together, despite using a different nomenclature: "dealer-based internalisation" and "in-house matching", respectively. A more limited number of works claim there is a need to *de facto* keep the two distinguished: Goldfinger, (2003) p. 18.

mechanism. The drawback is indeed that some of the reasons why they were created are frustrated[11].

Different structures entail different performances in terms of allocation efficiency, efficiency in terms of minimising transaction costs, integrity and fairness, investor protection. Any less extent to which one of the functions is accomplished is counterbalanced by the fact that others are fostered, so that each microstructure responds to needs which are peculiar to the agents which take part to that market.

Markets' microstructure[12] also impacts on the extent to which the market performs the aforementioned functions. The most important difference between market structures rests with the way in which orders interact. On this basis, order-driven markets have been separating from quote-driven markets. In the former, "all client orders for a security are directed to a central location without the intervention of an investment dealer or professional market maker"[13]. Investors' (limit and market) orders "interact in a continuous way (continuous auction market) or at regular intervals (batch auction)"[14]. These market structure ensures a high level of transparency and a precise price formation process. In the quote-driven markets a market-maker takes the opposite side of every transaction, posting its bid and offer price for any particular size of transaction. They allow "trades … [to] take place at any price upon which the client's broker and dealer agree in private negotiations. In this respect, these markets are in a better condition to accommodate large equity orders that need to trade anonymously"[15], albeit featuring a lower degree of transparency.

Securities markets are also distinguished in primary and secondary markets: the former being used for the placement of newly issued securities, and the latter serving the purpose of ensuring that, even after the point of issuance, trades continuously take place and securities go from hand to hand, depending on who values them the most at any subsequent point of time.

### *I.1.2. Financial Instruments and the Trend of Financial Innovation.*

Markets also differ with respect of the instruments traded thereon. Next to equity and debt markets, one can find derivatives and other structured products markets. Their introduction has been welcomed as beneficial to both the market and the investors, on the assumption that trades on these more complex instruments convey information about the value of investments and fulfil different needs.

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[11] In Europe, for example, Directive 2004/39/EC of 21 April 2004 has introduced a regulatory definition of MTFs and internalisation. The former can be operated by both investment firms and exchanges; in this capacity, they are subject to a licensing regime and benefit from a passport, enabling them to provide this service across the EU. Internalisation is a practise which all Member States should now allow and for which the Directive offers a common regulatory framework. Before this Directive, the practice had already developed in some Member States, although no obligation was in place mandating States to allow it.

[12] Lee (2002), p. 11, defines the term 'market structure' as the "rules governing how the trading system delivers the three functions of data dissemination, order routing, and order execution".

[13] Sabatini, Tarola (2002) pp. 17-18.

[14] Avgouleas (2005), p. 24.

[15] Sabatini, Tarola, *ibid.* MiFID leads to different pre-trade transparency rules in these two markets, as pointed out by FSA (2006d), p. 34.

The wave of financial innovation has long been hailed as one of the most important trends in financial markets. Innovative products have been held beneficial for the particular patterns of payments, risk-transfer and diversification opportunities they allow for[16]. But enthusiasms have been warmed down by the awareness that complex products contextually hide the high uncertainty of the cash flow (and hence the expected value) connected with underlying assets[17], feature higher opacity and/or higher transaction costs for reselling.

One of the most controversial examples lays with derivatives. They put together diverse judgements as to the volatility and value of an instrument. Consequently, transactions thereon have a highly informative content, adding to the quality of the price formation and lowering prices' volatility[18]. But where the underlying element is a stock index, private information is less relevant than it is with respect to an individual stock and hence derivatives do not contribute as much to price efficiency; moreover, derivatives markets are prone to uninformed speculators and, all in all, might feature increased volatility[19].

Derivatives should benefit investors insofar as they allow for risk-hedging and, in the last place, for tailoring the risks undertaken to the specific needs of each investors in light of her pre-existing portfolio. Nevertheless, complex structured products can be deployed to offer risk-return combinations which are blurring and hardly understandable. In the last place, they can shift to investors unwanted and unsuitable risks given their financial capacity, economic needs and risk-aversion.

#### *I.1.3. Other Trends. Market Integration and Ecommerce.*

The efficiency of financial markets has been both fostered and challenged by another recent trend: that of market integration. It was first led by intermediaries seeking to extend their businesses cross-border in order to expand their revenues. Integration triggers benefits for both markets and investors: it expands and diversifies investors' possibility to allocate their surplus and lowers the cost of capital for firms; it also allows for distribution of wealth across countries, which is crucial to foster growth worldwide, given that real economies are nowadays strictly interlinked.

The trend has featured different paces, especially for retail clients. In 2005 the European Parliament issued a report on the current level of integration of European financial markets, finding that the level of cross-border sales of retail financial products was still fragmented, and hindered mostly by legal and tax barriers, as well as cultural differences mainly in the domain of consumers' protection[20].

Integration, beside being one of the best opportunities for growth, might well also be one of the greatest threats thereto and the current financial crisis is a prove thereof. Defaults on sub-prime residential mortgage loans in the US market, coupled with the massive use of securitisations, have weakened banks' balance-sheets and spread out unquantifiable risks, determining a credit crunch with a worldwide contagion effect on real economy activities.

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[16] Bethel, Ferrell (2006).

[17] See OECD (2008), p. 13.

[18] Empirical studies on the relation between derivatives and price's volatility of the underlying stock are compounded in Damodaran, Subrahmanyan (1992).

[19] See Damodaran, Subrahmanyan (1992) and the studies referred to by Avgouleas (2005), p. 38.

[20] Parlamento Europeo (2005).

The same considerations hold for the marketing of products and services over the internet. Ecommerce of financial services has started from the late Nineties and has shown the potentials for representing the apex of the trend toward integration.

Ecommerce is one of the drivers for the increased participation of retail clients in modern financial markets[21], which is particularly important to ensure their after-retirement consumptions and need despite the lowering coverage allowed for by public pension schemes[22]. It entails a number of other benefits: a wider dissemination of information, higher comparability between products and service providers, lower transaction costs.

It also allows retail investors the widest access to financial services, which nevertheless is a double-edged sword: on the one side, it allows for international distribution of savings and extensive choice as to the products which better meet each investor's needs; on the other side, it creates the risk that investors light-heartedly purchase unsuitable products, fall victim of frauds, or simply purchase products which are unregulated in their Home State's jurisdiction without being aware thereof[23].

### I.2. Benefits and Risks of Intermediation.

Investment firms and banks carry out a crucial role in the functioning of modern economies. Drawing from *Greenwald* and *Stiglitz*'s lexicon, financial institutions have two functions: the 'agglomeration function', which is necessary insofar as single individuals have less capital at disposal than enterprises would cumulatively need; the 'transfer function'. This latter ensures that those who have resources are also in the position to invest – which is otherwise not always the case. These functions are accomplished by selecting among different uses of the funds (called 'selection function') and monitoring on how the funds are used ('monitoring function')[24], so that both investors and investees can diversify risk and return. All this is made possible by intermediaries being able to exploit economies of scale in collecting information and having superior evaluation models[25].

In other words, they can intermediate between investors having a financial surplus and business firms in need of funds, thereby facilitating the matching of investments' supply and demand. With the provision of investment services[26], banks and investment firms manage funds on behalf of clients, identify appropriate transactions, advise corporations on their funding needs etc.; with their lending activities, banks evaluate the quality of entrepreneurial projects and convey to them savers' funds.

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[21] Avgouleas (2003), pp. 6 ff.
[22] SIB (1995).
[23] Avgouleas (2005), pp. 30-31.
[24] Greenwald, Stiglitz (1992), pp. 38-39.
[25] Avgouleas (2005) pp. 54-55 stresses in particular the importance of the superior information and evaluation models.
[26] Banks perform the intermediation activity and impact on the efficiency of the market also when they take lending decisions and 'supervise' businesses in order to take this decisions. Nevertheless, this is not the focus of the work.

The way in which services are performed is crucial. When the services are properly performed, intermediaries contribute to the depth of the market and to the efficient allocation of resources. They evaluate investments' features and match them with the clients' needs, thereby allowing investors to enter the market. This holds all the more true for unsophisticated (retail) ones, which would refrain from contracting on their own[27] for the lack of the knowledge necessary to judge the investments. From this perspective, they have significantly been named 'protective gatekeepers'[28].

Contrariwise, improper performance can hamper investors' confidence and, hence, willingness to access the markets. As a consequence, the market depth is reduced and, together with it, its allocative efficiency.

The case of incompetent intermediaries aside, most (if not all[29]) improper performances of services are due to the existence of conflicts of interest between the firm and its clients (especially retail ones), which are being exploited by the intermediary.

For example, the firm might advice on the purchase of a certain instruments because is issued by another company of the group, although other instruments are better tailored for the client. Banks' lending activities also give rise to a number of conflicts of interest, which can be grouped around three categories: those arising were the bank is only performing lending; and those arising were the lending activity is coupled with the provision of investment services, which are two-fold[30]. A bank which grants loans to a client 'preferred, so to say', beyond what risks evaluations would allow for, is acting against the interests of the other (potential) clients which have been excluded. The same type of conflicts (between actual and potential clients) arises when lending is coupled with other services. For example, banks could advance monies – again beyond risks evaluation – to those who intend to invest them in issuances to which the banks has participated, as advisor or as underwriter, for example. Another type of conflict arises when investment services' provision is made dependant on previous lending activities. For example, the bank could shift the credit risk it has vis-à-vis an issuer by making a client subscribe its newly issued securities, regardless to whether they match the client's needs. In this case the conflict arises between the interest of the intermediary itself, and that of its (actual) client.

Nonetheless, improper performance does not always have such an effect. For example, investors might not respond to all exploitative behaviours: they can detect that the intermediary is unfairly charging commissions, but might just not take actions against this.

Also, if investors measure the professionality, competence and fairness of the firm on the revenues they obtain from the investments, improper performance is not detected in two cases: where clients do not gain considerably less than what they would have expected because, for example, the market shifts in a way which is favourable to them; where they gain considerably less, but there is a generalised unfavourable market shift which more directly holds causality to the loss.

[27] Levine, Loayza, Beck (2000) pp. 7 ff.; White (2004), p. 1.

[28] Giudici (2008), p. 418.

[29] Consider the case of an intermediary disposing of sensitive information which it exclusively shares, in exchange for some form of remuneration, with a preferred client who can consequently beat the market. Improper firm's behaviour does not necessarily derive from a conflicted interest it has vis-à-vis its clients. Nevertheless, one could also argue that in doing so, the firm is contradicting the interests of other clients, to whose detriment it has unduly manipulated the market.

[30] See Costi (2007), pp. 8-9.

It is not clear the extent to which investors measure fairness only on the basis of the monetary benefits accruing from investment activities. Behaviours which do not determine direct losses to any investor can affect the perception that investors have of the market and the players thereon. For example, intermediaries who disguise the existence of conflicts of interest, irrespectively to all exploitation, might convey the idea that they will not pursue investors' interest all the time. This might lead to under-confidence, which is detrimental to the market considered as a whole in the first place, but goes to the detriment of individual investors in the last place if it results in investment activities only being limitedly undertaken.

There is also mixed evidence as to the impact of individual exploitative behaviours on the market: it is just trivial from the point of view of the market, the fact that a client is charged more commissions than the service objectively justifies, while if intermediaries systematically detour resources away from their most efficient use, the efficiency of the market is diminished.

Given all this, it is controversial what should come first between investors' protection and market efficiency. No question when the two proceed together, and the loss arising from exploitation might goes beyond the economic loss of a single client[31]. When misbehaviours hamper confidence in a way that the allocation of financial resources through financial markets ends up being constrained in scale, the market loses the depth which is necessary to ensure allocation efficiency and business financing becomes subject to higher costs[32].

When a mismatch as above arises, the solution is made even more controversial in light of the debate on whether markets can at all entail correct pricing of securities at all.

Capital markets being able to fully (efficiently) reflect information in the assets' prices has long been debated by academics. The Efficient Capital Market Hypothesis (ECMH), grew in popularity during the Seventies (Jensen (1978)): its main proposition was that securities are priced efficiently, i.e. in a way that reflects the information available about them. It did not deny the possibility that individual investors act 'irrationally', but found evidence that the market can be overall efficient: a few smart monies can arbitrage among the inefficient prices determined by the over- and under-reaction of irrational investors, thereby compensating this inefficiency[33].

As *Fama* puts it, the efficiency hypothesis does account for over- and under-reaction, which are collectively regarded to as 'chance'[34]. The idea of the market being wholly efficient triggers a number of consequences: first, it solemnly seals the sufficiency of a force internal to the market for delivering an efficient output; thereby, it sanctions the deference of the regulatory intervention to the free market forces[35]. Second, it leaves in the backstage the irrationality of individual investors,

[31] Basel Committee on Banking Supervision (2008), p. 5.

[32] Directorate for Financial and Enterprise Affairs – Committee on Financial Markets - OECD (2008), p. 9. See also Hopt (2004).

[33] See Shiller (2002), p. 22, who summarises the terms of the ECMH which he nevertheless aims at challenging.

[34] Fama (1998), p. 284.

[35] More precisely, policy intervention could be confined to externality issues: the problem of non-correspondence of private and social benefits deriving from the generation of information (Hirshleifer (1971)); the problem of duplication of efforts among individuals to generate information (Coffee (1984); Diamond (1984)).

which is considered a mere intermediate eventuality in the overall picture, with no causal efficiency on the market result[36].

This hypothesis has been reformulated over the years: *Fama* (1970) has first distinguished three forms of the ECMH: in its 'strong' form, information (both disclosed and undisclosed) is reflected by securities prices; the semi-strong form implies that prices accurately and immediately reflect all disclosed information; in the weak form, markets only reflect historical information on securities. The difference is crucial in that it impacts on the profits accruing from the ownership of private information, and the damages created to market players by manipulative practices.

The importance of such hypothesis started declining during the late Eighties (*Shleifer* (2000), p. 23). The stock market bubbles of the Nineties put further pressure for the elaboration of a different explanation of how the market works[37].

Anecdotal evidence has been considered sufficient to identify what was then named "price-to-price feedback": when the first speculations arise and the prices shift upwards, a word-of-mouth enthusiasm gives rise to enhanced expectations about a further increases in prices and pushes the willingness to buy. Since the prices reached in this way are not sustainable in the long-term, the bubble itself carries the seeds of its burst, and the bursting is unrelated to the disclosure of new information[38].

The new strains of thoughts gradually gave rise to a discipline – the behavioural finance (which I will more thoughtfully analyse later) – which dramatically changed the terms of the debate, putting individual investors' irrationality and the overall market inefficiency in the foreground[39].

Before expanding on this new view, and analysing its consequences on the matter of firms-clients relationship, I shall now consider the findings of the economic literature on the transactions among market players (I.3.) to better point out causes and consequences of exploitation. Afterwards, I shall explain what insight this literature gives when applied to financial intermediation (I.4.).

## I.3. Economic theories on market players: relationships, contracts and biases.

### *I.3.1. Agency set-up and economic concept of conflicts of interest.*

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[36] Hence, the expected value of abnormal returns is zero, but because of chance the anomalies split randomly between over- and under-reaction: Fama (1998), p. 284.

[37] Scholars felt the urge to explain the so-called the 'puzzles of financial markets': Over- and under-reactions of asset prices to information; trading in excess when compared to their return; men and women different patterns of investment, the different premiums between risky and risk-free assets; the rate of sale of winner investments as compared to loser investments; the preference for cash dividends even when they entail tax disadvantages. See for example La Blanc, Rachlinski (2005), p. 13.

[38] These considerations mirrored those used to explain the popularity of the Ponzi schemes (see Shiller (2002), p. 19).

[39] See *infra*, I.3.2. and I.4.2.

Economic players often interact in a way which gives rise to what is known as agency set-up. Under this set-up, one economic agent (the principal) needs the other (the agent) to take actions to further his interest. Hence, the principal's welfare depends upon the agent's actions, which this latter can discretionary choose[40].

Problematically, the interests of the principal and of the agent are not aligned. First, for the realisation of the principal's interests, the agent has to apply an effort causing him a disutility; second, the agent might well have a personal interest which differs from the principal's one, or which can be better served with actions sub-optimal for the interest of the principal[41]. Therefore, the agent bears an opportunity cost (and, hence, a disutility) any time it acts for the principal's utility.

Thus, the agency set-up gives rise to a conflict of interest in its 'economic' (as opposed to 'legal') meaning. Economic agent A depends on economic agent B for the furtherance of his interest, which is nevertheless irreconcilable with that of the agent B himself. Depending upon the actions B decides to take, the conflict might or might not be exploited. Exploitation describes the situation in which B uses his discretionary decisions-making powers to further his own interest, negatively impacting on the principal's one. Nevertheless, exploitation is not inherent to the agency set-up, but in the end depends upon the costs and benefits which the person being able to take the decision derives from acting in his sole interest[42]; it depends, in the last place, on the principal's ability to remunerate the agents' disutility.

While conflicts are, in general, the result of an agency set-up, there is a sub-set of conflicts which derives from what is known as common agency theory. This conflict can be reworded as the "collision of interest of various principals… on the same side of the market" and the conflicts "between two principals on different sides of the market"[43]. Where principals take their decisions non-cooperatively, they give the agent conflicting incentives.

The most obvious example for this is that of an agent buying and selling the same goods for different clients which stand either on the same side of the market because they all want to buy, or on two different sides of the market, because one is willing to buy and the other to sell. Two buying clients want to obtain the good at the lowest costs; nevertheless, it might be the case that in the market for that good the transaction at the lowest price can only take place once, and that any subsequent transaction can only take place at an higher adjusted-price. Hence, the agent can only pursue the best interest of the principal whose trading intention is executed first.

If the agent acts for a buying and a selling principal at the same time, he faces two different interests. The former wants the agent to obtain the lowest price possible, whereas the latter wants him to obtain the highest price. If the agent buys for one the good offered by the other, he necessarily sacrifices one of the two expectations.

In both cases, which interest will be sacrificed depends upon the agents' possibility to make side contracts with one principal on the basis of private information[44]. For example, the agent can give preference to the selling principal's interest if he knows that this can entrench with him a profitable, long-lasting business relationship for the provision of a vast range of services in the future.

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[40] Hansmann, Kraakman (2004), p. 21; Cooter, Ulen (2004), pp. 226 ff.; Jensen, Meckling (1976), p. 308.

[41] Kruithof (2005), pp. 6, 7.

[42] Mehran and Stulz (2006), p. 3.

[43] Albertazzi (2006), p. 10. Hopt (2004), pp. 53, 61 ff.

[44] See Martimort (1996) for principals' ability to make side contracts with the agents.

The risk of exploitation was rebutted by the classic economic theory, allowing for the principal's ability to contract with the agent as to the efforts he should undertake. A basic assumption for this was that both parties have full and verifiable information as to the attributes of the goods being transacted, act rationally[45], and are able to draw complete contracts[46] that is, a contract which, for any possible future state of nature, allows for the identification of parties' respective rights and duties. Under these assumptions, "no party has incentives to take actions that adversely affect the other party because the buyer receives exactly what she pays for"[47]. In the end, parties themselves can bargain solutions which leads to a social optimum.

Contrariwise, information economics[48] has pointed out that asymmetric information lays at the heart of agency relationships. First, it is the very reason why they are set-up: the principal needs the specialised services of an agent, since he lacks knowledge as to his needs, the goods fulfilling them, and the actions which should be undertaken to obtain them[49]. Second, asymmetric information impacts on the way the principal-agent relationship can be managed. The principal cannot judge the quality of the services he is being provided with, lacks knowledge as to the future states of nature possibly impacting on the envisaged result, is in the impossibility of observing the actions taken by the agent. In its extreme version, the principal does not even know what they need[50]. It might be sub-optimal for him to put efforts in acquiring specific competences and information, i.e. more costly than beneficial if the competences needed imply high levels of sophisticated knowledge.

All this explains why it is difficult for the principal to bargain with the agent on the actions this latter should take and to identify the parameters for his decision making, in order to reduce the margin of discretion allowing for conflicts' exploitation[51].

In some principal-agent set-ups it is indeed possible to assume that there is no uncertainty, at the time of the conclusion of the deal, as to the future circumstances under which the agent will be called to act, and that the principal is able to *observe* the actions undertaken. Nevertheless, what always remains fettered is the principal's inability to *judge* the correctness of the decisions taken by the agent: this inability is the very reason why principals recur to the agency set-up[52].

Where outputs are observable, at least in theory, principals could give the agent incentives to reach the envisaged results, for example by linking the agent's remuneration to their achievement[53]. Nevertheless, in many principal-agent relationships the output is uncertain: it is not

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45 As Camerer *et al.* (2003), pp. 1214-1215, point out, even under the assumption of rationality, there was not common consent as to what 'fully rationality' should encompass. They nevertheless point out that all economists would agree that individuals are rational in that: they have well-defined preferences and make decisions to maximise them; the preferences reflect the true costs and benefits of the available options; under uncertainty, individuals have a clear picture as to how this uncertainty will evolve, and can incorporate new information in their beliefs.

46 And this is cost cost-efficient, since contracting is costless.

47 Mehran, Stulz (2006), p. 5.

48 A branch of economics which aims at analysing the interaction between information and economic decisions. Akerlof, Spence and Stiglitz have contributed to its formation with their studies on adverse selection, signaling and screening.

49 Clark (1987), p. 967: "the principal wishes the agent to take actions based on information which is available to the agent, not to the principal. Indeed this is the very reason why individuals delegate responsibility".

50 Dulleck, Kerschbamer (2005).

51 Kruithof (2005), pp. 7 and 12.

52 Clark (1987), p. 967.

53 Kruithof (2005), p. 11.

only linked to the agents' efforts, but also, to a larger or lesser extent, to casualty. Where uncertainty is high and the agent is risk-averse, it might well refrain from assuming the task, unless given insurance against uncertainty. Insurance can be provided by the principal himself, who could for example grant the agent a fixed remuneration for the efforts undertaken, irrespectively of the output realised. Nevertheless, given efforts' unobservability, these monies end up remunerating the mere fact that the agent is undertaking any action, not that he is taking the right one once applying the right efforts.

A number of problems arise from the agency set-up[54]. *Moral hazard* (also called *hidden action*) is the first of them[55]. It takes place where economic agents can undertake actions which maximise their utility "to the detriment of others, in situations where they do not bear the full consequences or, equivalently, they do not enjoy the full benefits of their actions"[56]. The sources of moral hazard are to be found in the fact that the agent's actions cannot be observed by its counterparty or, even where actions are observable, the information on which basis the actions are taken are of the agent's exclusive knowledge, so that the counterparty cannot appreciate whether the action is in his interest. The most common example for this comes from the field of insurance. Once having insured his car against theft, the car-owner has no incentive to adopt (costly) precautionary measures, not even the ordinary ones, aimed at reducing the probability of thefts. Hence, the insurer is exposed to a utility loss which it can not control, and is higher than the one it can predict having regard to the measures that car-owners ordinarily take to protect their good.

Rational principals do expect an hidden action and therefore discount the price they are willing to pay to the agent by the amount of losses which they are likely to suffer from the hidden action. This mechanism renders the hidden action costly to the agent, and gives the incentive to not undertake it. Through this discounting mechanism, principals do not pay for more than they actually receive, so that at least in theory, the aggregate utility is not diminished. Upon closer sight, though, it leads to inefficiencies. Principals cannot distinguish between loyal and disloyal agents and discount the price they are willing to pay to *any* agent. The honest ones are pushed out of the market because they face (additional and unrecoverable) costs for the exact performance of their duties, and the disloyal ones increase their market share. This situation is commonly described as *adverse selection* (also called *hidden information*), and is the second problem of the agency set-up. It arises where economic agents aim at bridging the problems of moral hazard but instead negatively bias the quality of services in the market[57].

#### *I.3.2. Players' cognitive biases.*

In contrast to the classic economic theory's claims about rational, utility-maximising individuals, behavioural economics draws from some social science literature and depicts limitedly rational individuals, with cognitive and emotional biases[58]. As *Camerer* et al. put it, since all the assumption of the classic economic theory have been relaxed (that of perfect competition,

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[54] Ross (1973), pp. 134 ff., is the first author having used the term "agency problems".

[55] Arrow (1985), p. 3. Stiglitz (1987), pp. 966 ff.; Kotowitz (1987), pp. 549 ff. Knight (1965), p. 260.

[56] Kotowitz (2008), p. 774. This problem has been long renown and testified, starting in 1776 with the widely renown work on "Wealth of Nations", where Smith pointed out that companies directors' being managers of other people's money, puts less efforts in watching over it than they would with their own money.

[57] It is here necessary to refer to the classical work of Akerlof (1970).

[58] The first studies were conducted in 1974 by Tversky and Kahneman, which named them 'prospect theory'.

that of full information), it appears quite normal to also relax those of agents' full rationality[59]. The extent to which the classic theory has been rebutted varies grandly: *Herbert*, for example, in its *Behavioural Model of Rational Choice*, has made the presumption of rationality less stringent, in order to account for the biases identified by the behavioural studies without denying the rationality outcome: he identifies some heuristics which contradict the full classical rationality, but still can be considered "procedurally rational"[60]. Under other, more 'drastic' interpretations, this 'new' economic agent suffers, as compared to the traditional *homo economicus*, from three bounds: bounded rationality, bounded willpower and bounded self-interest[61].

The first bound was introduced by *Simon*[62] to describe the fact that individuals feature limited cognitive abilities (computational skills, ability to retain and process memories). Therefore, when facing complex choices, they use rules of thumb, which represent a short-cut towards understanding the environment and deciding the actions to be taken in it: for example they identify ungrounded correlations, believe that "unusual trends have a greater than natural life span", "place too much weigh on recent or highly salient data", feature "overconfidence in their ability to control future events and control risks"[63] or, on the contrary, herd on other people's behaviours. They also change the amount of risk they are willing to bear depending on whether they stand for loosing or for willing, and the value they attribute to goods depending on whether they already possess them or not[64].

Bounded willpower describes the tendency of people to take decision which – as they are aware – are against their own interest in the long-term. Bounded self-interest appears when individuals maximise their utility also by rewarding fairness and punishing unfairness, i.e. act taking other people into consideration.

The first wave of behavioural economics has been subject to critiques: what opponents found – as it could easily be detected – the studies did not shed a comprehensive light on human behaviours, and were more tailored to address singular biases, having little in common and often proving opposite behaviours: "a laundry list departure from rational choice"[65]. Indeed, the first two models presented to describe biased investors (the *Daniel, Hirshleifer* and *Subramanyam* model and the *Barberis, Shleifer* and *Vishny* model of 1998) departed from different behavioural foundations to reach similar conclusions on over- and under-reaction by investors.

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[59] Camerer *et al.* (2003), p. 1218.

[60] Herbert (1955), p. 99, talks about a "fairly drastic revision" of the 'economic man': "the task is to replace the global rationality of economic man with a kind of rational behaviour that is compatible with access to information and the computational capacities that are actually possessed by organisms, including man, in the kinds of environment in which such organisms exist"

[61] These three bounds are considered by Jolls, Sunstein, Thaler (1997). Previously, see Kahneman, Tversky (1982).

[62] Simon (1955).

[63] Langevoort (1996), pp. 632 ff.

[64] Avgouleas (2005), p. 58 drawing from Gilson, Kraakman (2003), pp. 733-734 names six categories of biases: overconfidence, endowment effect, loss aversion, anchoring, framing, hindsight.

[65] Camere *et at.* (2003), p. 1216, describe with these words the critiques raised against behavioural economics. Fama (1998), p. 286, stresses the apparent inconsistencies of this literature highlighting that it does not succeed in replacing efficiency, since over-reaction of investors is as frequent as under-reaction.

Nevertheless, a second wave of studies has sought to put the scattered findings together for the attainment of a more scientific approach, and has started enquiring upon the several fields in which the findings could be usefully tested[66].

### *I.3.3. Incomplete Contracts, Enforcement and Reputation.*

The principal-agent relationship gives rise to incomplete contracts[67], which are endemic to economic transactions and which feature peculiar characteristics in agency set-ups.

Contracts are incomplete since it is prohibitive for parties to predict all possible states of nature, to observe the actions undertaken or the results obtained by the agent, and to draft an agreement which provided for them all. There a different explanations to incompleteness, each of which bears important consequences for the 'management' of the relationship between contractual parties.

Incompleteness might also be due to asymmetric information and, hence, arise in an agency set-up. If we define complete contracts as those which "specify each party's obligation in every *conceivable* eventuality"[68], we draw a definition which makes irrelevant the fact that not all possible eventualities are conceivable but only some of them, given information asymmetries. Nevertheless, some authors find that asymmetric information among contractual parties lead to contracts which can be defined incomplete, at least from one party's point of view: the informed party, which "may not want to make the outcome contingent on certain adverse contingencies by fear of signaling to the other party that these contingencies have high likelihood"[69].

Scholars assuming rational agents posit that it would be possible for these agents to correctly predict future contingencies, but they are willingly ignoring them: the benefits of including rules of conduct for each of them are not outweighed by the costs of doing so. A sufficiently low magnitude or probability of a contingency renders it sub-optimal to pay for "legal fees, negotiation costs, drafting and printing costs, the costs of researching the effects and probability of a contingency, and the costs to the parties and the courts of verifying whether a contingency occurred"[70] (so-called costs of writing contracts). Indeed, the benefits are also diminished by the courts' inability to understand the terms of the contract, verify if the contingencies have occurred and the actions undertaken, and enforce the contract (so-called costs of enforcing contracts)[71].

Incompleteness and judicial *ex post* un-verifiability are closely entrenched, and causes are sometimes undistinguishable from consequences: incompleteness can derive from the parties being aware that, in the end, courts can not enforce the rights embedded in the contract,

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[66] See Camerer, Loewenstein (2003), pp. 3-52.

[67] Incomplete contract theory was pioneered by Hart, who has considered it a development of the literature on transaction costs (and in particular of Williamson's contribution). Critiques to the original formulation of the theory come from Maskin and Tirole (1999).

[68] Hart (2008), p. 183.

[69] Tirole (2007), p. 4 (who also refers to other scholars working on the same assumption). Schwartz (1998), p. 280, names incompleteness due to asymmetric information 'endogenous incompleteness'. Ayres, Gertner (1989), p. 94, talk about 'strategic behaviour hypothesis'.

[70] Ayres and Gertner (1989), p. 93, name these as transaction costs. See also Shavell (1984).

[71] Hart (1990).

irrespectively to how 'accurately' the contract is drawn[72]. At its turn, under incompleteness, external enforcement (for example enforcement brought about by a judiciary body) is hampered.

Under incomplete contracts, endogenous enforcement strategies[73] might be helpful to control opportunism. Endogenous enforcement is that brought about by the parties to the transaction and is split up into 'bilateral enforcement' and 'multilateral enforcement', depending upon whether the enforcing actions come from the party directly involved in the transaction or from external persons, indirectly interested in the transaction. The (early) termination of the contractual relationship is an example of bilateral enforcement, whereas other potential principals refusing to contract with the agent is an example of multilateral enforcement[74]. Both rests on reputation, and cannot work where the incompleteness derives from parties' asymmetric ability to observe and judge the efforts and the actions taken[75].

Bilateral enforcement is a credible threat if the party against which enforcement can be brought obtains from the relationship a surplus which is higher than the one deriving from alternative opportunities. This can only be the case under three conditions: the costs of searching for another contractual partner after having lost the first one (switching costs) are low; the expenses incurred into for entering that specific contractual bound which might be non-reusable for other liens (sunk costs) are low; the market on which the transaction takes place is not fractioned, so that after interrupting the relationship there is no lapse of time before a new matching is realised.

Multilateral enforcement is closely entrenched with there being a repeated game with parties which are able to understand and value reputation. It requires external observability of the terms of the principal-agent relationship, of the actions undertaken by the parties and their correctness. It also implies that external parties are interested in the outcome of the relationship and can trust that other parties will evaluate the relationship and sanction the agent in the same way. Hence, beliefs and expectations must be coordinated.

Multilateral enforcement is hard to achieve. Since it is costly to monitor and judge agents' behaviour, each potential principal might well hope that other principals will punish the deviating agent and push him out of the market before he has himself to assume the costs of enforcement. This is the free riding problem affecting any public good[76], as enforcement is: each player benefits from other people's behaviour, and aims at obtaining this benefit without incurring in the personal cost of concurring to it[77]. It is perfectly rational from an individual's point of view not to undertake any action. But, as *Olson's*[78] studies has made clear, intelligent players rationally pursuing their

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[72] "Incompleteness arises because states of the world, quality and actions are *observable* (to the contractual parties) but not *verifiable* (to outsiders)": Hart (2008), p. 178. Following this interpretation, information asymmetry is held to taint the completeness of contracts, this asymmetry involves the contractual parties vis-à-vis third parties.

[73] Endogenous and exogenous enforcement were first defined by Bowles, Gintis (1993). For a literature review see Scoppa (2003).

[74] Hart (2008), pp. 180-181, refers to self-enforcing contracts, as to the contracts which (external) reputation mechanisms are likely to make 'complete'.

[75] Hart. (2008), p. 181.

[76] The main feature of public goods is non-excludability: where the good is provided, all members of a group can benefit from it, irrespectively to whether or not they have contributed to it.

[77] Stigler (1974), pp. 359-360: "the free rider proposition asserts that in a wide range of situations, individuals will fail to participate in collectively profitable activities".

[78] Olson (1965). See also Olson (2008).

own interest do not necessary lead to a socially optimal outcome, an outcome which is consistent with the interests of individuals as a group.

Scholars arguing for agents' bounded rationality hold that it is not possible for them to foresee all the contingencies, some of which are left out because of this inability[79]. This changes dramatically the terms of the relative position of powers among the parties, and of the possibility of enforcement strategies to 'compensate' for incompleteness. Indeed, biases affect the parties' ability to monitor and act as a consequence of opportunistic behaviours.

## I.4. Application to Financial Intermediation.

### *I.4.1. The provision of investment services to retail clients. Principal-agent set-up and conflicts of interest.*

The respective positions of investors and intermediaries[80] in the provision of investment services can be described as an agency set-up, the former being the principals, and the latter being the agent. Through this set-up, a number of activities can be performed.

Drawing from the list of the current European regulation, MiFID, one can mention: reception and transmission of orders, by which the firm routes the orders it receives to a third party for their execution; execution of orders on behalf of clients, meaning that firms act to conclude arrangements on behalf of their principals; dealing on own account, whereby the firm moves its own portfolio on the market, or act as a direct counterparty to its clients' trades; portfolio management, in which the firm manages the funds received from the clients; investment advice, which allows clients to receive tailored professional opinions on their financial needs and the investment which better match them; underwriting and placing of financial instruments, which is provided to firm-clients willing to fund their business by issuing securities; safe-keeping and administration of instruments for the account of clients; lending to clients to allow them to undertake investments; corporate finance services, performed for a firm-client to fulfil its needs of capital restructuring by means of issuances, mergers, etc..

As in any principal-agent relationship, the investment firm and its client feature different interests: this latter simply aims at having the best return on the monies invested, compatibly with her financial capability, her aversion to risk and the expenses incurred in for obtaining the services. The former aims at increasing its revenues, present or foreseeable. They can take the form of fees received for the normal and orderly provision of investment services, but additional revenues can be obtained acting in a way which contradicts the client's interest (through exploitation). In other words, they can make a financial gain or avoid a financial loss at the expenses of the client.

Both 'traditional' agency set-ups and common agency set-ups always arise in the provision of these services, irrespectively to how the intermediaries enter the market. They can do so, under either a specialised or a multifunctional capacity.

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[79] So called 'unpredictability hypothesis'. See Aghion, Bolton (1992), p. 473. Simon (1982); Williamson (1986).
[80] Banks and investment firms are collectively referred to as intermediaries throughout this work. MiFID allows them both to provide investment services.

On the one hand, with multifunctionality, a full range of services can be offered, and economies of scale and scope follow. If this abates the costs for providing the services, firms are able to serve even the marginal potential client, with reduced willingness to pay.

On the other hand, specialisation allows for a stronger position on the market vis-à-vis competitors, and higher revenues allowed by the capture of marginal businesses. Also, specialisation can mitigate the burdensome information asymmetry which weigh on professional players as well, when they face transaction on specific markets or particular instruments[81].

In both, an agency set-up arises, for example, when the firm purses its interest by inflating the commissions charged or by artificially increasing the number of investments undertaken on behalf of investors, well beyond what would be necessary and useful in the light of the results attained. Firms can also seize to sell their services at all costs, despite being aware that the range of products offered does not fulfil clients' declared expectations. In these cases the firm's interest directly collides with that of the client.

With specialisation, the form under which the common agency arises is that of the agent serving two principals on the same side of the market (since the firm offers only one service) for example, two investors willing to buy (the same) financial instruments. Both purchases can be executed at the same time, but one client can well gain more if her purchase takes the priority over the other client's one (which conversely looses from being postponed).

Under multifunctionality the common agency also arises under the form of the agent serving principals which stand on opposite sites of the market; for example, an issuer which is placing its issuance through the intermediary and an investor willing to buy a suitable instrument, whereas the issuance is not suitable for her needs. In these cases, the interest of the clients are contradictory one to the other. Such conflict of interest among clients can translate into a conflict between the interest of the intermediary and that of one client: the only condition to it is that the intermediary decides to pursue the other client's ('preferred client') interest with preference, for example because it can count on future businesses from her part[82]. These situations increase the opportunity-cost of not pursuing some clients' interest at the expenses of other clients; potentials for making gains or avoiding losses are greater, so that the expected returns more easily outweigh the risk of 'being caught': hence, motives for exploitation also increase.

Financial instruments' performance is tied, not only to their complex structure, but also to the unpredictable fluctuations of the markets. Hence, it is *ex post* impossible to link negative outcomes to either malfeasance or bad luck. A negative outcome can bear any, some, or full link with the intermediary's behaviour. Even when it mainly derives from adverse changes in the market, the intermediary's behaviour might have contributed to it. Two consequences arise: first, the agent's efforts are even less verifiable than in other principal-agent set-ups, since the outcome is not even a proxy for disloyal behaviour. Second, and consequently, since the output is limitedly dependant upon behaviour, there is limited scope for giving incentives which ensure intermediaries' proper conduct[83]. Conclusively, *ex post* impossibility to distinguish between malfeasance and bad luck renders it difficult to contract on agents' behaviour[84].

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[81] If clients are found to discount the price they are willing to pay to non-specialised operators for the threat of conflicts' exploitation, specialisation is also the way of not suffering from this 'selection'

[82] See *supra*, I.3.1., on the collusion between the agent and one principal in a common agency framework.

[83] See *supra* I.3.1., the discussion on 'output uncertainty'.

[84] Kroszner, Rajan (1993), p. 476.

### *I.4.2. The players.*

As mentioned above, and as difference with other agents, intermediaries always contextually perform a wide range of activities, both on own account and on the account of clients, and serve more than one principal at the same time. Also, they are often framed in group structures, thus bearing not only an individual interest, but also an interest as a group[85]. Beside the fact that the occasions for exploitation increase, as already mentioned, their information advantage (as to the market, its player, etc) as compared to their principal is also extremely important.

The information asymmetry between parties inherent to the principal-agent set up is also exacerbated by other circumstance when it comes to financial intermediation. One is the opacity of the goods on which the intermediation takes place. Financial instruments are commonly included in the category of either 'credence goods' or 'experience goods'[86]. As pointed out above, financial markets are facing two main trends: financial innovation is the first one, leading to increasingly sophisticated and complex products; technological progress is the other one, allowing for the widest access to the markets, especially from the part of retail investors. Hence, one can easily conclude that the problem of goods' opacity is increasing in severity and extension.

As any other principal, investors can limitedly place constrains and exercise control over the firm's behaviour. In addition to this, the relationship with the intermediary is devised so that the agent is (more) risk-averse (than the principal): the risk of unfavourable market shifts is a risk that the investor bears by definition, in exchange for the higher yields that investments might bring him[87]. Let us briefly recall what said above (supra …) about these situations. The agent will only undertake the activity in exchange of a fixed return. But if the return is ensured irrespectively to the efforts undertaken, the principal who can not observe the efforts is subject to exploitation.

Importantly, investors use the services of intermediaries to bridge their information asymmetries with respect of the end borrowers, but are subject to the same asymmetry with respect of the intermediary. All this holds more the so true for retail client[88]. Indeed, there is no unique classification of retail clients across jurisdictions world-wide and, in some cases, retail client can also be legal persons ('firm-clients') [89]. Nevertheless, irrespectively to how broad the category is, it describes the least sophisticated investors in the market, in terms of financial capability and understanding of the investment possibilities.

The above-described studies of behavioural economics, applied to financial markets, have given rise to the works labelled as behavioural finance[90]. Behavioural finance refuses to label the suboptimal behaviour of individual investors as 'chance', and widely refers to the cognitive biases elaborated by behavioural economics.

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[85] White (2004), p. 2; Benston (1994).

[86] Goods whose quality cannot be ascertained at all or only after a costly process of assessment (even after repeated purchases), respectively.

[87] Kruithof (2005), p. 11.

[88] Mehran and Stulz (2006), p. 16.

[89] For example, Annex II of Directive 2004/39/EC, undertakings are always retail clients, unless they meet two of the three following criteria: a total balance sheet of euro 20 millions; a net turnover of euro 40 millions; own funds for euro 2 millions.

[90] Behavioural finance has been described as a "collaboration between finance and other social sciences": Shiller (2002), p. 30, who also offers a comprehensive discussion of these studies.

Scholars have focused on both general and services-specific investors' biases. Generally speaking, it has been proven that investors act with overconfidence in their ability to pick 'winning' investments, and that their decisions are subject to framing effects, i.e. their choices vary depending on how the decision is framed. For instance, they may purposefully avoid selling losing stocks longer than warranted to avoid realizing a loss on their investment. Conversely, they may treat gains as "house money," making overly risky investment decisions with the gains[91]. All this impacts on the ability of investors to draw complete contracts, enforce them, discount the possibility that intermediaries are facing conflicts of interest, and consequently reduce the price they are willing to pay for the services.

It gives further insight as to the features of the agents on the markets in its discussion of the ECMH, which I shall therefore summarise. Behavioural finance does not dramatically challenge the ECMH when it posits that the average individual investor does not rationally behave[92]. It rejects the objections moved against irrationality arguing that there is no wonder that both over-and-under-investments can be detected, since, first, "there is no fundamental psychological principle that people tend always to overreact or always to underreact"[93]; second, "the mere fact that anomalies sometimes disappear or switch signs with time is no evidence that the markets are fully rational"[94].

In these studies, the reason why the market fails to act efficiently lays with sophisticated investors and their incentives to act, as determined by irrational investors. In short, the interaction between these two types of investors is such, that smart monies cannot arbitrage and thereby ensure the efficiency of the market.

*Barbeis* and *Thaler* point out that arbitrage entails risks and costs[95], so that a few arbitrageurs do not compensate for the inefficiency of 'irrational' investors. The more prominent of these risks is that, even when the arbitrageurs can detect the 'right' predictions, if they fully try to compensate for other investors' behaviours, they are exposed to the adverse market shifts entailed by these latter's irrationality[96]. Although other explanations have been proposed, the overall result of market inefficiency does not change. For example, smart monies might exacerbate the problem of 'fool investors', since it is remunerative (and rational) for them to anticipate what these latter will do[97].

This discipline has further added to the picture sophisticated investors' biases, some of which are rational, while others denote irrationality[98]. *Bainbridge*[99] finds in career and reputation

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[91] Shefrin, Statman (1985). Choi (2003), p. 10.
[92] See *supra* I.2.. Scholars arguing for imperfect rationality admit that the ECMH has given "important insight that securities prices are influenced by a powerful corrective force. If prices reflect public information poorly, then there is an opportunity for smart investors to trade profitably to exploit mispricing": Daniel, Hirshleifer, Teoh (2002), p. 140.
[93] Shiller (2002), p. 31.
[94] Shiller (2002), p. 32.
[95] Barberis, Thaler (2002). Their studies, and especially their points on the risks of arbitrage, piggyback on those of Black (1986), DeLong, Shleifer, Summers, Waldmann (1990), Shleifer, Vishny (1997).
[96] Among the costs one can mention the fact that arbitrage implies higher trading commissions and fees and the need for taking short positions which – when not hampered by the regulation – entails additional costs.
[97] Herding can be a rational behaviour for all investors, since it was proven to allow for short-term financial gains: Froot, Scharfstein, Stein (1992), p. 1462.
[98] Babcock, Loewenstein (1997).
[99] Bainbridge (2000), p. 1038.

two motives for herding: professional investors are judged by the market (and their potential clients) on the basis of their performance as compared to that of their rivals; they build up their reputation on the circumstance that they act consistently with the main trend or the conventional wisdom, and if they fail in providing their clients with adequate returns, they are less heavily sanctioned by the market if herding is detected[100].

Some thematic studies have empirically verified the problem of cognitive biases, and in particular investors' ability to detect conflicts of interest. They have shown that investors can discount the possibility that analysts face such conflicts and give biased advice[101]. Nevertheless, these works also point out that when one controls for types of principals the results are not the same: small (individuals) as opposed to large (institutional investors) traders, fail to account for analyst biases due to conflicts of interest[102].

In the same vein, some scholars analysing Initial Public Offerings (IPOs)[103] claim having found evidence that investors are willing to pay less for banks-underwritten than for investment firms-underwritten issuances. When banks underwrite IPOs, the risk is that the issuance is 'sponsored', regardless to its quality, to provide issuers with the liquidity necessary for repaying a loan that the bank itself has given. To some, the observed under-pricing[104] of these issuances as compared to those promoted by investment firms leads to the conclusion that investors can discount the price they are willing to pay in light of the possible conflicts of interest exploitation[105].

Contrariwise, other studies find evidence that investors are willing to pay more for banks-underwritten than for investment firms-underwritten securities. This hints to a certification role of banks, and to investors' ability to take it into consideration[106]. Problematically, both groups of empirical works argue in favour of investors' rationality, but do not agree on what investors rationally take into account, whether the exploitation of conflicts or the certification role of banks.

In particular, causes and consequence of the discounting effect is controversial. In a study devoted to this issue, *Kroszner* and *Rajan*[107] found that discounting takes place also when in-house departments underwrite comparably better securities than other competitors. Hence, this sheds a light on the fact that the alleged 'rationality' is on the contrary 'irrationality' and creates inefficiencies in the market.

If one considers that discounting can be led by consideration other than investors' rationality, these studies are not enough to conclude for investors' rationality. Firms might just accept the under-pricing proposed by the underwriter because of the bargaining power the

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[100] If one concentrates on the gatekeeper function of these professionals, herding entails a particularly worrying market failure: Coffee (2004), p. 329.

[101] Mehran, Stulz (2006), p. 5. More on this *infra*, Chapter V.

[102] Malmendier, Shanthikumar (2006), p. 38: as a consequence, "there is little indication that market forces and self-regulation are sufficient to induce more sophisticated decision-making among small investors. In order to prevent small investors from naive investment decisions rather intrusive regulatory interference appears to be required".

[103] As a general warning, all these studies draw from US-market data.

[104] Where under-pricing is measured as the difference between the first day price and the subscription price.

[105] Allen, Faulhaber (1989); Ang, Richardson (1998). Following Beatty, Ritter (1986), investors require up-front compensation for uncertainty.

[106] Puri (1999).

[107] Kroszner, Rajan (1994).

underwriter, when it is able to put at use a previously acquired deep knowledge of the issuer[108]. Both underwriters and firms can use discounting as their dominant strategy. Underwriters are indeed compensated through a commission which is a fixed percentage of the capital raised, but lower offer prices generate a greater volume of trades and therefore allows for more trading commissions[109]. For firms, under-pricing could be a way of signaling to the market their quality, and in particular their ability to perform in the long term in a way that allows to recoup the discount[110]. As a free publicity mechanism, it could generate subsequent high levels of trade[111].

### *I.4.3. Incomplete contracts and external controls over intermediaries. Industry's structure, competition, reputation.*

Many sources of contractual incompleteness can be found in the bargaining between the intermediary and its clients: the intermediary is likely to maintain its superior knowledge through the strategic behaviour of not disclosing contingencies which might occur. By so doing, it can preserve the value of the gains that it can extract from the contract. Also, most states of nature in the financial markets are unforeseeable[112]. This adds to intermediaries' discretion, and makes the value of the bargaining fully conditional upon the agent's behaviour after the 'point of purchase'[113].

Drawing from the previous part on contracts' endogenous enforcement (*supra*), I will now explain why both bilateral and multilateral enforcement are not fully achievable in these contracts.

The conditions ensuring that reputational damages create incentives not to exploit conflicts of interest are not fulfilled in financial markets and the threat of endogenous enforcement is not particularly credible[114]. First, consider the types of services. They are mostly connected with open-ended long-term investments. As a consequence, "poor performance is seldom established conclusively, since a turnaround is always possible"[115]. On top of that, given the time-lag between

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[108] There is empirical evidence that prior lending relationships influence the choice of the underwriter Ljungqvist, Marston, Wilhelm (2003), who also demonstrate that prior underwriting has the same effect. Klein, Zoeller (2003), 21. Nevertheless, nothing in these studies allows to understand whether the choice is made because of positive synergies or because issuers prefer underwriters which will probably more aggressively place the issuance, despite its quality, to recoup their loan.

[109] See Butler, Wan (2005), Hughes, Thakor (1992), Tinic (1988) for these and other underwriters' incentives to under-pricing. Schmidt *at al.* (1988), Michaely, Shaw (1994), Carter *et al.* (1998), find discounting when the intermediaries' reputation is already low.

[110] "Signalling hypotheses … suggest that high-quality issuers might choose to underprice to advertise a high-quality issue to the market. Underpricing is modelled as an equilibrium phenomenon that separates high-quality firms from low-quality firms…. These signalling models argue that only high-quality issuers can afford to underprice and recoup their cost in seasoned issues. Low-quality issuers cannot expect that the market will not detect their type before further issues and cannot afford the same low subscription prices in IPOs": Allen, Faulhaber (1989). See also: Grinblatt, Hwang (1989), Welch (1992), Ibbotson, Jaffe (1975), Klein, Zoeller (2003).

[111] Shiller (1990); Welch (1992).

[112] Ayres and Gertner (1989), pp. 92-94.

[113] Llewellyn (1999), p. 35.

[114] Nevertheless, Benston (2000), p. 289, argues that "financial products [are] almost always offered by institutions that have incentives to invest in and maintain reputations for fairness and honesty".

[115] Langevoort (1996), p. 660.

initial investment decisions and the realisation of possible losses, cheating might be the rational choice for brokers: "the return will come rather quickly, while the losses – if they occur at all – are likely to occur later in time"[116].

Second, consider the features of economic agents, in particular of retail investors. We have already discussed the problem of bounded rationality. What hasn't been stressed enough is the length of clients' learning process, and the fidelisation effect intermediaries can create when they stand out also as advisers. This lowers the "likelihood of conscious customer dissatisfaction"[117], even in competitive markets. Moreover, given the costs of bringing lawsuits, small investors are unlikely to sue[118].

Third, consider the industry. The banking industry has traditionally been concentrated: capital endowment requirements impose high entry costs, and operators have exploited the synergies deriving from agglomeration. Nevertheless, for the provision of investment services, banks compete with a range of other financial firms. In the EU, this trend has been favoured since banks compete with investment firms in the cross-border provision of services. As a consequence to deregulation and technological advances entry costs have sunk, making the market more contestable[119].

Despite this, the investment services' industry still appears, at least to the eyes of retail investors, dominated by firms with a strong branding. These investors are biased towards locally-visible institutions[120] so that, even if allowed to provide services cross-border, firms have to undertake the costs of setting-up branches; investors are also easily locked in with the intermediary, and the main cause to it has to be found in high switching costs, difficulties in assessing the quality of the goods proposed, costs to terminate the relationship, especially where the provision of more services is bundled together.

Even assuming that the structure of the industry is competitive, virtuous intermediaries would not have either incentives or the information to exploit competitions' mechanisms. Let us consider the problem of incentives first. In other industries, better performing firms would signal their quality, for example by showing their clients the existence of conflicts, the extent of other operators' possible exploitation, and the degree to which they do not exploit them. As some scholars argue, in the financial industry this signaling would create awareness as to the level of malfeasance and require a costly race to the top from the part of intermediaries; alternatively, it could cause mistrust toward the entire system, the signaling intermediary included[121]. Coming to information, "a competing broker lacks the information necessary to demonstrate exploitation

[116] Langevoort (1996), p. 659.
[117] Langevoort (1996).
[118] Posner (1998).
[119] Molyneux (2002), De Bandt, Davis (1998).
[120] In Italy by 2005 investment services were in majority a national banks' business, in terms of both the number of banks providing them (around 640 over 786 firms authorised to their performance[120]), and the gross revenues (62 percent). Investment firms realising the 52 percent of the category's revenues in the provision of investment services had an Italian banking parent company. 22 percent of the revenues were to be found with investment firms whose parent companies were either a foreign bank or a foreign insurance company. By the end of 2006, 71 percent of the investments was managed by firms controlled by national banks, and 19 percent by firms with a foreign banking parent company (Consob (2007)).
[121] Langevoort, (1996), p. 666.

absent a desire by customers to entrust that information to a new broker – something they are unlikely to do absent some dissatisfaction in the first place"[122].

Reputation is hampered by investors' cognitive biases and the fact that they normally use mental short-cuts to appreciate the fairness of a single firm belonging to the intermediation industry. This allows intermediaries to free ride on reputation-investment of other intermediaries[123] and decreases the incentives to individually 'invest in fair behaviours' for the purpose of building up reputation.

An argument in favour of the existence and functioning of a reputation-building process comes from the prudential regulation. Across Europe, prudential regulation imposes initial and on-going capital requirements. Therefore, an 'hit and run' strategy which would be rational in some game-settings would be over-costly[124].

In addition to this, the Basel II regulation, aiming at controlling the risk intermediaries undertake imposing the retention of capital cushions (which reduces their ability to expand), requires firms to evaluate and cover with an adequate amount of capital also the reputational risk. Since this risk can easily arise in case of investors' exploitation, it is in the interest of intermediaries to maintain the necessary standing and be able to demonstrate this effort to the supervisory authorities, in order not to suffer from operativity constraints[125].

### I.5. Rationale for Regulation.

The debate on there being a rationale for financial markets' regulation is lively and complex. When it comes to conflicts of interest and the exploitation of retail investors, it is probably less controversial, despite being undeniably crucial.

*Benston* is one of the main opponents to (non prudential) regulation[126]. As he notices, the "list of potential difficulties faced by consumers could be applied to a wide range of nonfinancial products and services"[127]. Hence, in *Benston*'s view, the named imperfections do not justify a regulatory intervention on financial markets, as they clearly do not justify it in other fields. Moreover, the author considers financial products as generally easier for nonexperts consumers to

[122] Langevoort, (1996), p. 666.
[123] Black (2001), p. 788.
[124] Benston (2000).
[125] See also *supra*, endnote 14.
[126] Benston (2000), for example, despite opposing the rationale for regulating financial markets with conduct of business rules recognises the need for prudential regulation. One should notice here that, at least in its latest developments, prudential regulation is strictly interlinked and requires other (conduct of business) regulation. Basel II for example requires firms to hold capital which is sufficient to address reputational risk. Such risk arises, among other things, from conflicts of interest's exploitation when exploitation is detected and punished by the market. Nevertheless, reputational risk is very hard to measure, and is normally detected *ex post*, in the light of existing reclaims, petitions, litigations, redresses, which depend upon rights being conferred to investors. It can only be detected *ex ante* by confronting the behaviour of intermediaries with the conduct mandated by law. Therefore, both *ex post* and *ex ante* measurements require a legal definition of conflicts of interest and a description of the actions which correspond to a proper management thereof.
[127] Benston (2000), p. 288.

evaluate than other products. He mentions deposits, loans, securities, and posits that for other products the rule “do not buy what you don’t understand” should apply. *Benston* does not deny that consumers could take some times before being fully aware of the products’ features, even when it comes to unsophisticated products; nevertheless, the problems associated with other goods (for example poorly repaired houses) might well take many more years to be detected.

True is that – to stick to *Benston*’s example – in the purchase of electronic appliances consumers have inadequate information about “how the sets were manufactured, the time when specific parts might fail, the cost of repairing the unit …; suffer from ‘asymmetric information’ – they know less than the manufacturers; … probably find it difficult to ascertain the quality of an offered warranty …; … probably would ‘ride free’ on other consumers' investigations”[128]. True also is that, even for these purchases, the sellers’ interests might well conflict with the purchasers’ ones.

In all transactions agents feature different interests: for example in a purchase, the buyer wants a good which the seller surrenders in exchange for money. Opposite interests match each other and this allows for the conclusion of transactions. Nevertheless, the electronic appliances’ example above differs from the case of investment in financial instruments in that it does not feature an agency set-up and therefore implies a different type of conflicts of interest.

Where no agency set-up is in place as in *Benston*’s example, and therefore each economic agent only counts on its actions to pursue its interests, scholars normally debate on whether the most informed party should share its competences with the other party. Scholars often argue for the negative, since efforts to acquire information and specific competences are socially desirable, and should be promoted. Such efforts are only undertaken if an agent can reap the private benefits of investing in these efforts. Obliging the agent to share the benefits, by sharing the competences with its counterparty, would give the incentive not to undertake beneficial investments[129].

When an agency set-up exists, and hence one party is not on the footing of autonomously pursuing its own interests, the terms of the debate differ. Conflicts’ exploitation is not about shifting welfare between the two parties, but crucially about possibly losing welfare. Let us exemplify this mentioning two groups of cases. First, the cases in which one party needs the collaboration of another party to protect a particularly important good it has: health, in the case of the patient-doctor relationship. Second, the cases in which having at disposal the expertise of another person is the condition for taking up business activities: entrepreneurial activities, in the shareholder-director relationship.

In the first case the sensitivity of the good protected renders it necessary the proper performance of the tasks of the agent. Otherwise, the loss on the principal would go far beyond the money he has purposelessly spent. In the second case, the abstention from economic activities would entail a spill-over effect on the economy considered as a whole, whose negative impact goes far beyond the fact that individuals renounce to one possible way of employing their surplus. Hence, these cases are all but similar to the example proposed by *Benston.*

Scholars link the need for financial markets’ regulation to the market failures described thought this chapter[130]. *Llewellyn* concentrates on asymmetric information, opacity as to the quality

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[128] Benston (2000), p. 289.

[129] Zingales (2004), p. 19, posits that dissemination of proprietary information should not be mandated when it can amount to a loss of competitive position. He does not deny that this can also happen in the financial industry, and mentions the case of the disclosure of portfolio composition by mutual funds. Nonetheless, he ends up affirming that such case happens less frequently in this industry.

[130] Llewellyn (1999), p. 21; Kruithof, p. 10; Walter (2003), pp. 13-20; Cranston (1990) pp. 142-143.

of financial products, under-investment in information by consumers and agency costs, whereas *Armour* considers market power, incomplete contracts and margin for post-contractual opportunism[131] and *Zingales* finds scope for regulation "when contracts are incomplete and renegotiation is hampered"[132].

Arguing in favour of a regulatory intervention in the field of investment services does not mean backing the idea that any regulation is better than no regulation. It means that a regulation is desirable where the costs it entails are offset by its benefits[133], where the same benefits cannot be achieved otherwise at a lower cost. Hence, a 'zero failures' regulation would be uneconomic[134].

Efficient (and, hence, desirable) regulation from a cost-benefits point of view is the one addressing the market inefficiencies at the least cost as compared to its benefits and the costs entailed by other non-regulatory solution[135].

Therefore, the regulation should identify the inefficiencies relevant to the regulated situation, having regard to the player, their contracts, and the goods circulated with the transactions. A regulation on the provision of investment services should in particular identify the features of the average investor, be it rationality coupled with a mere information asymmetry, or cognitive biases.

For financial markets, scholars have also stressed the need to consider that this field is "an evolving business environment". "Regulatory measure that are overly detailed or too restrictive may induce distortions in the allocation and pricing of financial resources and may limit the ability of financial institutions to respond to changes in the competitive environment"[136].

When it comes to regulating intermediaries' it is also important to set priorities between the aims of investors protection and market efficiency. Recalling what said in the outset of this chapter, one can argue that the end of the regulator should be the promotion of sound and efficient markets. Indeed, it is through markets of this type that resources are properly allocated. Investors' protection, bringing about confidence in the market, can be considered an ancillary aim. But the opposite view has also some standing. Markets are deep as long as investors are willing to act on them; the willingness to invest decreases with exploitative behaviours.

There is no conclusive view as to which aim should come first, whether markets' protection or investors' protection, given the mentioned interrelation, and the virtuous circle between the two. Different national systems express different views on this point: in Germany, for example, investors and market protection are considered two sides of the same coin. The FSA currently has as its statutory duty that of the protection of investors. In Italy, protection of savings is considered

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[131] Armour (2000). Köndgen (1998), p. 118: since "markets do not normally achieve an efficient balancing of rights and obligations in principal-agent relationships … fiduciary standards of conduct have long been added to an agent's obligation by courts and legislators".

[132] Zingales (2004).

[133] Walter (2003), p. 13. Moloney (2004), p. 20.

[134] Demski (2003), 52.

[135] Walter (2003), p. 13. Put in the words of the Directorate for Financial and Enterprise Affairs – Committee on Financial Markets - OECD (2008), p. 2, "high-quality regulation may be defined as that which produces the desired results as cost efficiently as possible". The two main components of this definition are that regulation succeeds in achieving the intended objective (i.e. is effective) and does so at reasonable cost (i.e. it is efficient). Also, (p. 4), the intervention should be based on "due consideration of alternative mechanisms for addressing the problem". Clearly, this also implies that regulation should force the regulated to "do something that they would not otherwise do": Goodhart (1995), p. 218.

[136] Directorate for Financial and Enterprise Affairs – Committee on Financial Markets, OECD (2008), p. 12.

a public aim itself, and is formally recognised in the fundamental Chart. An Italian scholar has therefore analysed the costs and benefits of the regulation in these terms: "the logical method for defining the trade off between effectiveness of regulation and its costs comprises the following steps. The first step is the definition of the minimum level of investors protection which must be attained, irrespective of the amount of costs implied, given the public nature of such an objective. Second, if policy markets want to reach a higher degree of protection, a marginal analysis must be conducted by comparing the costs and the utility of each additional piece of regulation…"[137].

I will not argue that the one or the other has to come first. Nevertheless, the regulator has sometimes to set priorities between the two. Where, for example, intermediaries: act putting their interest before that of the clients, without these latter being damaged; create a 'suspect' of misbehaviour, for example constantly avoid disclosing their conflicts, irrespectively from the existence of a loss for their clients. Consider the case where the intermediary places an instrument issued by another firm of the group it belongs to, with preference to other instruments. The intermediary does make a financial gain which it would not realise otherwise. Nevertheless, the client might well not suffer any loss from it[138]. For example, the type of investment could be as suitable as other possible investments, with respect to its financial needs and risk-aversion. Also, the investment could ensure an expected/actual return comparable to that of other instruments.

In these cases the regulator can adopt two different approaches: that of protecting clients' trust by safeguarding them from any merely 'suspicious' behaviour, irrespectively from the outcome; that of exclusively safeguarding the monies of the clients.

The cost-effectiveness of the regulation can be evaluated considering whether, after having identified its aims in light of the specific features of the markets (its peculiar failures[139], its players[140] and the goods transacted thereon), it deploys tools which are commensurate to them.

Traditional law and economics has fiercely rejected all paternalism, i.e. the regulatory intervention which forces or prevents choices for the individuals' own good. As it has been described: "the idea of 'consumer sovereignty' plays a large role; citizens, assuming they have reasonable access to relevant information, are thought to be the best judges of what will promote their own welfare"[141].

While traditional law and economics is based on the classic economic theory and its assumption of rational individuals, and the present discussion also aims at benefiting from the behavioural studies (and behavioural finance in particular), better is to recur to that part of the law and economic discipline which has embedded them, i.e. the behavioural law and economics.

Behavioural law and economics has made two points. First it has expanded the scope for a regulation; second, it only advocates for the regulation which addresses failures detected with an

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137 Cesarini (1998), pp. 65-66.

138 IOSCO (2007), 6: "While not all conflicts of interest may result in harm to particular clients or diminish market integrity, all conflicts increase the risk of these outcomes (both in terms of the likelihood and the impact of such outcomes)" thus diminishing confidence and efficient market performance.

139 Directorate for Financial and Enterprise Affairs – Committee on Financial Markets - OECD (2008), p. 5.

140 The need for regulation decreases for every increasing level of investor's sophistication following, among others, Biasin (2007), p. 400.

141 Jolls, Sunstein, Thaler (1998), p. 1541.

eye on agents' biases. It finds a case for regulation for naïve segment of the public[142] and does not completely reject paternalism[143].

In 2003 two studies were released on this matter. They share the same aim, but emphasise different concerns. To overcome the suspiciousness normally ingenerated by this terms, *Sunstein* and *Thaler* (2003) point out that a paternalistic approach can indeed be libertarian as well, and that the two lay in a continuum, depending upon the degree of choice left to economic agents. They call it a 'libertarian paternalism' and stress its benefits for consumers' protection.

This study's efforts are devoted at showing that, although institutions can try influence people's behaviour, choosing for example the default rules, there is a libertarian approach in the fact that the regulation introduces of pre-determined legal bounds, from which agents can opt-out, so that choice is not fenced off.

Depending on how costly it is for individuals to depart from the standard rule (and choose self-determination), the approach features a larger or smaller degree of paternalism[144]. The degree of choice allowed for should be set depending upon the costs of decision and the cost of errors, which are esteemed taking agents' bounded rationality and the different possible market-settings into account.

The study by *Cramer* et al. (2003) is less wary as to the suspiciousness around paternalistic approaches, and openly backs one form of them, which it calls asymmetric paternalism. Where the regulator's sophistication and the distribution of rational agents in the market allow for it, this approach allows to enact a fully paternalistic solution for some players, and a fully libertarian solution for other players. The result shall nevertheless be that the benefits for those who would otherwise err (net of the implementation costs) outweigh the costs for those who would not need be protected.

Upon closer view, the two studies are perfectly harmonious one another, as also proved by the fact that they both present the same examples of applicable regulatory measures. Among these: default rules, the obligation to provide or re-frame information, mandatory cooling-off periods, limits to consumer choice. They entail a different mixture of libertarian and paternalistic approach as well as bring different costs on those who would be capable of making rational decisions, and benefits on those who need to be guided in this direction.

Let us now more closely consider the measures named by these studies.

Default rules are rules which should legally apply in case individuals do nothing. They account for a number of biases, such as the *status quo*, endowment and the omission/commission ones, which can be detected when individuals inefficiently do nothing, either because they value more the endowment they have (or their previous choices) than the potentials for amelioration, or because they regret more mistakes made out of commission than those made out of omission.

Default rules are seen as a powerful engine[145], but scholars agree on the difficulty to devise them. In the simplest case-scenario, the 'majoritarian default' should apply, i.e. the default rule

[142] Daniel, Hirshleifer, Teoh (2002), p. 182.

[143] Camerer *et al.* (2003), p. 1211.

[144] To heighten the costs of departure from the rules, the legislator can provide for procedures to which opt-outs are subject. Alternatively, it can allow for departure only on certain selected terms. Lastly, it can burden departing behaviours with deadweight costs (sanctions): see Sunstein, Thaler (2003).

[145] Zingales (2004), p. 28, points out that default rules, have "an enormous effect in framing competition among firms especially in markets with high search costs".

which is best for the majority of individuals. In this way, most people are accorded what is best for them, without the costs of making such decision by themselves, and without the losses if the decision is not taken. The solution is not as simple as that, and it might be sub-optimal depending upon: whether the majoritarian class only slightly outnumbers the minoritarian class(es); the breadth of the differences between the optimal majoritarian and the optimal minoritarian defaults, the willingness and the ability of those who should opt-up of the default to do so, the costs for not doing so[146].

The other problem of default rules is that they imply that the regulator knows what is best for contracting parties. If this is not the case, it cannot mimic the market, i.e. reproduce what parties would have contracted for, but should better depart from it, and translate what parties for sure would not want. In this way, the regulator indirectly obliges parties to contract around the default and thereby disclose their private information and their preference[147]. This technique eases the burden on the regulator, but implies that all parties have perfectly clear what they would need or are willing and able to spend resources to find it.

The mandatory provision of information is deemed beneficial for the low costs it entails, even where seemingly trivial information should be provided. It addresses information asymmetries of some individuals, while leaving informed one on the footing of taking their autonomous decisions. The costs of this technique go down to problems of compliance costs, which can nevertheless be abated with forms of standardisation.

Nevertheless, this technique is also controversial: as it has been pointed out, it is not cleat what individual need the most, either information or the elimination of their cognitive biases (and whether information eliminates such biases[148]). Moreover, the provision of extensive information might have unwanted effects such as information overload, which affects parties ability to understand and act upon the information[149].

Other examples of paternalism are: the requirements that individuals are provided advice (with or without predetermination of its content) as well as the imposition of cooling-off periods, which delays (impulsive) decisions to take place[150]. Both entail considerable explicit costs, but cooling-off periods also trigger implicit ones, opportunity costs since they risks irremediably delay efficient transactions.

Indeed, the delay reduces the benefits for all parties to a transaction and it is difficult to assess whether this loss is counterbalanced by the fact that cooling-off periods avoid the losses linked to unwise decisions. In addition to this, the existence of a lapse of time before a party is bound by an agreement does not ensure that the party will use the time to process information and take conscious decisions. Lastly, some beneficial bargaining might be lost, since an apathy effect can kick in and prevent the conclusion of the deal[151].

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146 For these reasons, studies of optimal default rules have been conducted on a topic-by-topic basis. They have most commonly addressed the problems of insurance and of employees' participation to pension plans: Choi *et al.* (2003), who show that rules which just force a decision to be taken also have an important effect on participation in pension plans.

147 Ayres, Gertner (1989).

148 The need for promoting investors' literacy has been challenged on these grounds: FSA (2008b).

149 Camerer *et al.* (2003), p. 1235.

150 Under an alternative form, cooling-off periods allow for immediate conclusion of a deal but render it reversible within a certain time.

151 See Camerer *et al.* (2003), 1239.

There is no unique answer to these questions: the cost of delay and the possibility that some deals are avoided depend on the features of the goods transacted, the biases of their typical buyers (for ex. whether they have a strong *status quo* or omission/commission biases), the ratio between buyers who would benefit from these periods and those who would not.

Irrespectively to the measures taken, the benefit of this approach is that it is flexible enough – and willing – to take account of different situations in which regulation is needed. It accounts for different bounds in rationality; markets with different levels of imperfections (especially informative ones), and for different types of regulators. In particular, the cost of departing from a pre-determined rule can set at a high level if rule-makers are self-confident about their possibility of making better decisions than individuals. Thus, this approach flexibly addresses the problem of rule-makers suffering from cognitive biases as any other agent (assuming that, among these bias, there is not the over-estimation of one's abilities). On the contrary, it does not solve the problem of regulators being captured by lobbies and serving its self-interests.

One of the reasons why there is no consensus as to the need for paternalistic approaches lays with the fact that government actors, being themselves individuals and, hence, boundedly rational players, risk incurring in the same mistakes as the other (private, so to say) players. In a different vein, other scholars argue that regulators are indeed rational self-interested players. On this assumption, two different conclusions can be drawn. One argues that since politicians wants to be re-elected, they obtain voters' benevolence by correctly distributing wealth and creating efficient regulation[152]. The other argues that the self-interest results in rule-makers only being prone to lobbying capture (public choice theory)[153]. To some, though, this situation can be overcome where the regulation is devised at a supranational level: the supranational regulator would, in this view, be less subject to the pressure of an industry trying to further local needs[154].

In most cases, cost and benefits are hard to measure[155]. Nevertheless, there are two cases in which the problem of determining their exact value can be bypassed. The first occurs when the incentives created by a layer of rules render redundant another layer of rules. In such cases, the marginal benefit of the second layer is reduced to nil, but the entire cost of compliance with two sets of rules is borne. The second case occurs when the regulation imposes contradictory duties, which cannot be effectively fulfilled, so that the threat of legal sanctions can lead to a duplication of efforts and, again, of costs which are not offset by additional benefits.

The regulation of conflicts of interest is a supranational concern, and should be regulated as such[156].

The benefits of integrated financial markets have been discussed above. Integration can be hampered by national regulators impeding, for example, foreign intermediaries to access their markets, for the purpose of protecting local incumbents. Access is impeded not only where rules deny *tout court* authorisation to foreigners to act, but also where they widely differ across countries: in this case, intermediaries willing to act in different jurisdictions would be bounded by

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[152] Peltzman (1976), Becker (1983).

[153] Stigler (1971).

[154] Snell, Andenas (1999), p. 258, though, argue for the contrary.

[155] Goodhart (2001), pp. 155 ff. See also Oxera (2007c); Directorate for Financial and Enterprise Affairs – Committee on Financial Markets, OECD (2008), p. 11.

[156] But taking into account the fact that a regulation which is levelled at a supranational levels might have redistributive effects: it is likely to trigger more compliance costs for the intermediaries belonging to jurisdictions whose rules more extensively have to be amended as a consequence of the supranational intervention.

innumerable rules, and the costs of compliance would outweigh the benefits of expanding the business. Conduct of business rules, such as those relating to conflicts of interest are among the rules which can inefficiently burden intermediaries.

On the other side, integration brings in each market foreign intermediaries and new products and services: under this framework, investors need enhanced protective measures to approach the market with untouched confidence. If one only considers that where markets are integrated, investors' loss of confidence on one market has spill-over effect beyond national borders, the need for a common level of protection is even clearer. Risks having supranational dimensions clearly need to be addressed by supranational and coordinated measures.

### I.6. Legal concept of conflicts of interest.

The regulation addressing the problem of conflicts exploitation burdens the agent with the duty to act in accordance with the principal's interest. Hence, in legal terms, conflicts of interest arise when a person "has a duty to decide to act solely based on the interests of another person, while the choice he makes has repercussions for its own interests"[157]. This explains why, in legal terms, conflicts of interest should be reworded as "conflicts of interest and duty"[158]. Unlawful exploitation therefore takes place when the duties devised are breached.

A prerequisite to this definition is the identification of the principal's interests which are worth protecting and their relative importance with respect to other 'goods', such as market efficiency[159].

The regulator should also decide whether to only give relevance to actual conflicts of interest, or to potential conflicts of interest as well, i.e. the conflicts which might be, but are not, exploited. Their relevance conclusively depends upon the evaluation of what is relevant for the protection of confidence. If one holds that investors only react to actual losses of their funds, then the concept of exploitation should be entrenched with actual economic loss; if one holds that investors are also able to perceive the potential for conflicts inherent to a certain set-up, then some behaviours can be banned irrespectively to the direct impact they have on managed monies.

Lastly, it should decide how to treat conflicts between clients which only indirectly amount to a conflict between the intermediary and the non-preferred client, pursuant the common agency theory (*supra* I.3.1.).

### Conclusions.

This Chapter has presented the consideration which will guide the rest of the work. Preliminarily, I have given some insight on the role of financial markets, and the relation between

[157] Kruithof (2005), p. 2; Kumpan, Leyens (2008), p. 83.
[158] Kruithof (2005), p. 2; FSA (2006), § 9.7.
[159] GAO (1989) pp. 8-9.

investors' confidence and market efficiency. I have put the former in the foreground as a natural consequence of the fact that the core of the work considers investors protection, and in particular of the protection of those investors who need it the most (the retail ones). Nevertheless, causes and consequences are difficult to separate, and MiFID is a multifaceted regulation which takes both into consideration and necessarily makes some compromised choices.

The focus on retail investors has triggered the analysis of the role of financial institutions, which a scholar defined 'protective gatekeepers': their intermediation role is crucial for the participation of investors to the market. They put together the resources of a number of clients, and transfer them to their most efficient use, as they can judge thanks to their superior evaluation models. Not only more transactions, but also more efficient ones are made possible. In fact, at least in theory, intermediaries apply for investors their ability to evaluate investment opportunities.

Nevertheless, such gatekeepers can also put investors protection at stake. The case of incompetent intermediaries aside, most (if not all) improper performances of services are due to a voluntary misbehaviours of firms vis-à-vis their clients. The existence of conflicts between the interests of the firms and those of their clients and the intermediaries' desire to exploit them lay at the heart of these misbehaviours.

To explain this, the Chapter has analysed the economic theories on the market players, on their relationship, their contracts and their biases. I have in particular described the principal-agent set-up and the threats it poses in terms of conflicts of interest's exploitation.

In my description of such a set-up, I have given preference to the points made by the behavioural economics: unlike the finding of the classic economic theory, it allows to explain why players (and principals in particular) are on the footing of neither judging the actions undertaken by their agents, nor obtaining and verifying their proper behaviour simply by bargaining for it. Behavioural economics acquaints the existence of cognitive biases which render the principals' exploitation easier to undertake.

It has followed a description of the types of contracts which can be entered into under the principal-agent set-up, namely incomplete contracts which can only be enforced under very strict conditions (for example the existence of reputational mechanisms). For this purpose, I have drawn from the part of the economic literature which allows for the incompleteness of contracts even where only one party lacks information.

In the following part, I have explained how these findings apply to financial intermediation to further expand on the matter of its threats. In the provision of investment services, intermediaries and their clients act as agent and principals (respectively) of a principal-agent set-up. Nevertheless, this agency situation is much more problematic from the point of view of the protection of principals.

As principals, investors are affected by biases similar to those identified by the behavioural economics and more deeply enquired upon by the studies of behavioural finance. Although some thematic works have seized to argue for investors' rationality, I held that their results cannot be conclusive. As agents, intermediaries are more risk-averse than their principal. Therefore, the structure of the remuneration the former are paid can play little role in controlling their incentives to exploitation. Unlike other agents, intermediaries always serve different clients which gives rise to a common-agency set-up. Under this setting, the agent acts for two principals (which can stand on the same or on different sides of the market): when their interests collide and the intermediary has incentives to give preference to the interest of one among them, the problem of exploitation becomes more acute.

The intermediaries-clients relationship also differs from other principal-agent set-ups in that the information asymmetries and the occasions and motives for exploitation are more acute. To address these points I have spent some words on the (the opacity of the) goods which are exchanged on financial markets, on the operativity of the intermediaries and on the structure of the industry.

The analysis of the market for intermediation services has been useful to explain why the incompleteness of the contracts between firms and clients cannot be completed by some form of endogenous enforcement. I have in particular stressed the high level of concentration of this market. Even allowing for the opposite conclusion, i.e. that a sufficient level of competition can be detected in this industry, a number of studies has shown that intermediaries lack the incentives to use the levels which would make competition work as an external control over firms' self-serving behaviours.

Since my main focus is a set of European regulations, after having briefly presented the debate on the rationale for regulation and on the benefits of having a supranational (as against national) regulation, the last part of the Chapter has discussed the tools for a cost-efficient evaluation.

I now turn to the analysis of the current European regulation on conflicts of interest. The aim is that of assessing whether it has the potential for being cost-efficient, especially whether it correctly identifies the problems and adequately addresses them. As mentioned above, its interaction with other pieces of European regulation interact is not irrelevant.

The next Chapter contains the first stage of the analysis of MiFID: it compares the 2004 Directive to The 1993 Investment Services Directive, and detects the novelties it entails with respect to this forerunner. I will focus on both those which directly impact on the issue of conflicts' of interest, and those which are more general. These latter are useful to appreciate the new framework, and it will be interesting to assess whether such framework is contradicted by specific provisions on clients protection.

# Chaper II

## The European Regulation of Conflicts of Interest. From the ISD to MiFID.

This Chapter aims at evaluating the way in which Directive 2004/39/EC (L1 Directive)[1] and its level-2 implementing measures[2] address conflicts of interest by analysing the changes they have brought about as compared to their forerunner (Directive 93/22/EEC, hereinafter: ISD[3]).

For this purpose, the Chapter assesses whether, and to what extent, the ISD was not sufficient, and whether – and to what extent – MiFID addresses these failures.

This first analysis only takes MiFID's general architecture into consideration, but will in the end lead us through the most crucial aspects of the new regulation.

### II.1. The Investment Services Directive.

The Investment Services Directive was adopted having in mind the need for both deeper markets' integration and more intense clients' protection[4].

Before that, the basic tools for enhancing the cross-border activities have been the Treaty freedoms and in particular the freedom of establishment (arts. 43 ff.) also by way of setting up branches, and the freedom to provide services (arts. 49 ff.), as interpreted and applied by the European Court of Justice (ECJ).

Member States could not enact measures exclusively applicable to non-nationals willing to conduct businesses on the basis of the aforementioned freedoms, safe where necessary to pursue the objectives explicitly listed in art. 55 of the Treaty (public order, public security and public health); nevertheless, in principle, each Member State could retain its rules as applicable to national firms, and apply them on a non-discriminatory basis to non-nationals.

This mechanism alone could not ensure non-discrimination: the same rule might well be more burdensome to comply with for non-nationals. Upon closer sight, it became evident that all restrictions, even those equally applicable and *de facto* non-discriminatory, could hinder cross-border activities and where a negation of the freedoms themselves. The most advanced interpretation of the Treaty freedoms therefore required all measures a Host State wanted to apply to cumulatively fulfil a number of conditions: a direct link with a general interest not safeguarded

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[1] Directive of 21 April 2004, O.J.E.U. L 154/1 of 30 April 2004.

[2] Commission Directive 2006/73/EC and Commission Regulation 1287/2006, both of 10 August 2006, O.J.E.U. of 2 September 2006, L 241/1 and L 241/26, respectively (hereinafter: L2 Directive and L2 Regulation). I will collectively refer to L1 Directive, L2 Directive and Regulation as to MiFID.

[3] Of 10 May 1993, published in O.J. L 141/27 of 11 June 1993.

[4] For a thoughtful analysis of the ISD see: Fusetti, Recine (2007), pp. 155-156.

by the national rules of the home Member State of the service provider, the objective necessity of such measures, the impossibility to pursue the same aim by means of other and less restrictive measures. All in all, this amounted to Member States being obliged to mutually recognise the controls of the other States as equivalent to theirs and to disapply the different national rules, safe for the principle of the general interest (so-called 'negative integration of the market').

The ECJ played an important role in so defining the Treaty rules, at least in a number of business sectors. Nevertheless, a regulatory intervention was necessary in the field of financial services, were the objections based on the general good could be the rule, and not the exception, given the different (long) national traditions in this field and the different needs for protection deriving from the departing features of the markets and the investors concerned[5].

The ISD introduced the principles of national authorisation and Europe-wide passport. Firms could perform services across Europe on the basis of a unique authorisation – that of their Home State[6]. This has been labelled as "mutual recognition of authorisation and of prudential supervision[s]"[7]. On this basis, firms could both freely provide services and establish abroad, within the whole community. Host States could not require compliance to additional (prudential by nature) measures, and were therefore obliged to mutually recognise the other country's authorisation and supervision as equivalent to their own.

Scholars agreed on the fact that the mechanism envisaged by the directive substantiated a 'prefect' mechanism of mutual recognition. As a difference to the above-described ECJ's principle of mutual recognition, under the 1993 directive States could not put any justification forward for the application of more stringent national rules, having the directive already identified "the degree of protection of public interests deemed necessary but sufficient": "Member State[s'] competence to invoke the general good as an exception to mutual recognition … [was] exhausted" by the (minimum) harmonisation of the directive[8].

The second concern of the European regulator was the 'management' of conduct of business rules aimed at protecting clients, which was entrusted to the State "where the service is provided" (art. 11). Minimum harmonisation obliged States to grant that firms act loyally and fairly with competence and diligence, in the interest of the clients and of the market integrity; that they have the necessary resources and procedures to finalise their activities, to be used in an effective manner; that they gain knowledge of the clients' experience, financial situation and investment objectives and provide them with due information; that they endeavour to avoid conflicts of interest and, where not possible, ensure to all clients fair treatment[9]. The rules devised for the implementation of art. 11 had to be applied in such a way as to take account of the professional nature of the person for whom the service is provided. The directive also recognised the importance of organisational requirements for the purpose of minimising the risk of prejudice to clients' interests, but art. art. 10 simply required a "good administrative and accounting organisation", as well as "adequate internal control procedures, compounding rules on employees' personal transactions.

An exception to these provisions was laid down for the provision of investment advice: pursuant art. 11, states could decide not to apply conduct of business rules to this services. They

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[5] See Ortino (2006), p. 202.

[6] Arts. 3, 4, 6, 8-10, 14, 17 of the ISD.

[7] CESR (2006), p. 3.

[8] Tison (2002), p. 90.

[9] Beltrami (2007), pp. 343-344: firms would have to prove that they exclusively furthered the client's interest.

could therefore neglect the principle following which firms have to try to avoid conflicts of interest and, where not possible, they should treat clients fairly.

The ISD went little beyond these principles[10]. As a minimum harmonisation tool it only endeavoured to identify the desired aims, leaving member states free to enact the rules to attain them. Upon closer sight, though, the directive also only apparently fixed the aims for the national regulation.

For example, it was not clear whether firms had to avoid conflicts (as it seems from art. 11) or their exploitation (emphasised by art. 10). This is crucial since avoiding conflicts *tout court* would mean impeding the constitution of multifunctional intermediaries and their aggregation in group structures[11]. Also, the duty to avoid conflicts *tout court* would be eligible for enforcement regardless all proof of damages to clients' financial interests. The vague reference to conduct of business as a means of avoiding conflicts was not stringent enough to bind states in an effective way, and the reference to fair treatment opened up to many possible applications, leaving firms exposed to the uncertainty of the national courts' application of local rules without openly binding them for the benefit of investors.

As a consequence, Member States' approaches for implementing art. 11's core objectives varied dramatically: some exclusively copied-out the principles – which can nevertheless be considered as a non-compliant way of implementing a directive – others added extensively to them. The retention of differences across States was also backed by the wording of the directive, which made safe the "special conditions" to which service performance could be subordinated in the interest of the general good (arts. 17(4) and 18(2), second subparagraph, for the setting up of branches and the free provision of service, respectively).

The result was an uneven level of overall protection and, from the firms' point of view, an extensive amount of legislative possibilities to be aware of[12]. In addition to this, the identification of the applicable rules was not easy because of the way in which regulatory competences were allotted between home and host states, i.e. the way in which the conflict-of-law rules worked.

Broadly, the ISD required the application of the home state's organisational rules and the host state's conduct of business rules. Upon closer sight, though, the directive left unclear the law of which State was applicable. The boundaries between what was 'prudential' and what was

[10] Also, the directive made no clarity as to the legal nature and "effects of the rules of conduct to be drawn up by Member States": Tison (2002), pp. 73 ff. In the end, conduct of business regulations were enacted by means of self-regulation, administrative rules to be sanctioned by national authorities, rules giving rise to contractual claims. For a description of Member States' implementation of art. 11 ISD see Tison (2002), pp. 77 ff. and Wymeersch (1998), p. 35 ff.

[11] At the time, costs and benefits of multifunctionality were still amply debated across Europe, and solutions leaving a margin for manoeuvre are recurrent in the directive. For example, on the one hand, it allowed banks to become members of regulated markets directly (without being obliged to set up a specialised subsidiary for this purpose) and, hence, to collectively perform non banking activities next to the traditional banking ones; on the other hand, it required the Commission to assess the consequence thereof after 5 years, having special regard to the danger of conflicts of interest.

[12] Let us now consider one example for this: art. 11(1) required States to devise and apply conduct of business rules "in such a way as to take account of the professional nature of the person for whom the service is provided". Lacking a shared view on which clients should be treated as professionals and which as retails, the same client could fall under the former or the latter category, depending upon the State of their establishment. Therefore, firms contracting with similar clients in more than one State could find themselves to comply at the same time with more and less stringent obligations.

‘conduct of business’ regulation and, hence, between the home and host Member States’ competence were unclear. The conflicts of interest regulation and the employees’ transactions exemplify this. Although “the limitations arising from the internal control mechanisms on employees transactions (e.g. priori authorisation rules) [which are part of the internal organisation and, thus, of the prudential controls] rest on assumptions that employees should not as a rule effect transactions in which they are personally involved as employees” (a conduct of business rule)[13].

Applicable conduct of business rules where those of “the Member State where the investment service is provided”. This could be (and has been) interpreted in different ways: the State of establishment of the branch, that of residence of the investor[14], that of the market where the transactions were executed[15]. From many parts, it was held that the Directive could ground the competence of a number of Member States at the same time.

The ISD listed for the first time the investment services and, hence, the principal-agent situations possibly giving rise to conflicts of interest, and allowed investment firms and banks to perform core and non-core services together, but the standalone provision of non-core services was left to unregulated entities[16].

But the directive did not contain any definition of what constitutes a conflict of interest. Only, it made clear that member states’ regulations shall take into consideration both the collision of the intermediary’s interest with that of its client and the collision of different clients’ interests (art. 10).

All in all, the ISD’s framework could negatively impact on clients’ protection and increase intermediaries’ costs of compliance, thereby reducing both the demand and supply side of the market for cross-border services.

### II.2. From the ISD to MiFID.

After the ISD was enacted, a number of factors played a role in increasing the potential for investments. The introduction of the European Monetary Union and the common currency, decreased the impact of the exchange rate risk; innovations in technologies and financial products opened up for new investment possibilities; the number of retail investors facing the market increased.

All in all, the rapid growth in the cross-border provision of services increasingly emphasised the problems inherent to the ISD framework, and in particular the regulatory arbitrage[17] and the low degree of investor protection it allowed for[18].

Both pro-active response and anticipation of predictable future trends where at the heart of the decision to re-consider the regulatory framework[19]. The November 2002 Commission proposal

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[13] Tison (2002), p. 72.
[14] See Herbst (2003), p. 212.
[15] See, for this debate, Dax (1999), pp. 10-11.
[16] See for example Rinaldi (…) Le società.
[17] IOSCO (2007), 3.
[18] Pacces (1999), p. 6; OECD (2000); European Commission (2000).

for a new directive on investment services concluded that the existing framework for undertaking investment business on a cross-border basis in the EU was no longer effective. In particular, the ISD failed to "provide sufficient harmonisation"[20].

Given the ISD's failures, let us now turn to MiFID and see the way in which it has addressed the challenges created by the new trading environment.

MiFID draws from some 'main ideas' of the ISD: the Home State's authorisation enables firms to perform services throughout the community, by setting up branches as well as by using the freedom to provide services (arts. 5 and 6(3) MiFID).

Nevertheless, it represents a major reform of the previous regime. Its innovations are both general and specifically concerned with the problem of conflicts of interest. General innovation having an impact on the regulation of conflicts of interest are: the allowance for firms' multifunctionality; the introduction of new services; the enhanced harmonisation; the clarification of the home state/host state competences.

### *II.2.1. General innovations.*

#### *II.2.1.1. Firms' multifunctionality.*

MiFID allows for firms' multifunctionality: banks can perform investment services and activities, investment firms can provide a combination of services; all intermediaries can take part to groups, i.e. become entrenched with firms conducting other businesses[21].

Home states can in principle rule against multifunctionality, but this would mean put their companies at a competitive disadvantage vis-à-vis (foreign) firms. On the contrary, where a home states allows for multifunctionality, host states cannot derogate to it by imposing additional organisation requirements on incoming firms (arts 31 and 32 of the L1 Directive); also, they cannot indirectly hamper it adopting conduct of business rules (art 32 (7) of the L1 Directive) which make the conduct of multifunctional businesses more difficult.

This choice was not a given: the ISD was wary as to the benefits of multifunctionality. During the public consultations for the adoption of MiFID it was still not sure that this would be the end result. Participants to the consultation where asked whether the separation of certain activities should be made mandatory[22]. In the end, multifunctionality was adopted as one of the most common trends of the regulation worldwide.

The provision of more than one investment service by investment firms has been only limitedly controversial. The US has always allowed firms to act as both brokers and dealers at the

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[19] For a discussion of these evolutions and the risks inherent to the ISD see in more detail: IOSCO (2007), pp. 3-4.

[20] European Commission (2002), p. 64.

[21] Arts 13 (10) and 18 (1) of the L1 Directive. This can also be inferred from the fact that art. 22 of the level-2 Directive does not mention neither conflicts' prevention, nor conflicts' removal, which are mainly obtained through separation of businesses.

[22] CESR (2004d).

same time. In Europe such allowance was enacted later on: in the UK from 1986, as a way of allowing British intermediaries to face against US competitors[23].

The integration between traditional (commercial) banking activities and investment activities went down a more difficult path. At the turning between the second and the third decade of the 20th Century, US banks allowed to perform both activities came under the spotlight for a number of malfeasances to the detriment of investors[24]. This was read as the result of major conflicts of interest which banks could exploit because of the different activities they undertook. To contrast the loss in confidence, the *Glass-Steagall Act* of 1933 prohibited the existence of commercial and investment activities under the same roof and, thus, banned the universal bank[25]. In the same vein, the Bank Holding Company Act of 1956 prohibited holding companies that owned a bank from owning or controlling companies engaged in non-banking activities. However, as the regulator for bank holding companies, the Federal Reserve could allow (and actually did allow for) exceptions[26]. The Federal Reserve relaxed the prohibition twice, in the mid-Sixties and in the second half of the Eighties[27]. By 1989 one could read between the lines of the United States General Accounting Office's report the belief that even extending banks' operations, the scope for clients' exploitation could remain limited and be counterbalanced by increased competition[28]. The pace of the interventions to relax the *Glass-Steagall Act* increased sharply thereafter[29] and in 1999, the *Gramm-Leach-Bliley Financial Services Modernization Act* completely superseded the separation mandated back in 1933.

The same held true for Europe, where the model of the integrated commercial and investment bank was recognised in 1989 by the second Banking Directive[30], which allowed a single entity to perform all the banking and financial activities, with only limited exceptions such a that of the management of collective investment schemes.

All most recent pieces of regulation confirm the approach of leaving intermediaries free to choose their organisational set-up. The Basel II Accord on capital adequacy[31] does not mandate any

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[23] See Poser (1988), p. 95.

[24] They placed junk securities without giving proper information to the investors, transformed high-risk loans in financial instruments to be placed in the portfolio managed on behalf of their clients; traded on the bank's securities on the basis of confidential information.

[25] Sections 16, 20, 21 and 32 of the *Banking Act*. The Act trenchantly prohibited: commercial banks from underwriting, offering, negotiating instruments issued by firms; investment banks from accepting deposits; banks' management and officers from undertaking activities linked to their firm's business.

[26] GAO (1989), p. 20. Exception where granted where additional safeguards against conflicts of interest (such as internal control mechanisms) were enacted.

[27] In the mid Sixties, the FED allowed commercial banks' subsidiaries to underwrite commercial papers, public entities' bond issuances, mortgage-backed securities. This was made conditional upon two circumstances: revenues from these activities should not exceed a fixed amount of total revenues (5%) and there should be organisational separation between banking activities and investment activities. In 1987 it allowed banks to set up subsidiaries entrusted of organising bonds IPOs (operativity in shares IPOs was admitted shortly afterwards, in 1990), under the condition that the revenues from this activity did not exceed 10% of the total revenues.

[28] GAO (1989), pp. 27-29

[29] By 1995 the revenues from investment banking activities could amount to one-fourth of the commercial bank's total revenues, and in 1997 these latter were also allowed to acquire, not only to set up, investment banks.

[30] Directive 89/646/EEC of 15 December 1989, E.C.O.J. n. 386 of 30 December 1989.

[31] Basel committee, adopted in 2004 in revision of the first Accord of 1988.

particular form of business organisation, but it does give incentives so that the organisation autonomously chosen by the intermediaries does not contrast with the safe and prudent management. It does it through the mechanism of capital requirements, cushions of capital banks should hold to counterbalance the risks they face: the more the risks, the more capital should be held. Multifunctionality increases the reputational risk[32] in that it creates opportunities to exploit conflicts of interest. Integrated banking and investment activities are not prohibited, but banks are bound to hold more capital and face restrictions in their operativity, unless they either opt for separation or introduce alternative devices against conflicts' exploitation.

The straight position of the current European regulation in favour of multifunctionality has to be welcomed. It is in line with an un-constrainable market trend[33], desirable from the point of view of both the intermediaries, their clients and the economy as a whole[34].

For the benefit of firms, integration allows for diversification of business risk and allows for economies of scale and scope[35]. As an example of the former, Poser[36] mentions the reduction of administrative costs. As an example of the latter, Kroszner and Rajan[37] mention information benefits: putting together the information obtained through – let's say – the lending business and the project finance business, banks dispose of a larger amount of information which can be re-used for the provision of other services, and acquire a deeper insight on the markets and the needs of their players.

This allows intermediaries to perform service at a lower cost or to provide new services in the light of the (better perceived) business' needs[38]. When more intermediaries compete in the same business, they are also more likely to fight the competition game by passing the benefits of reduced costs onto clients[39].

Firm-clients benefit insofar intermediaries, under a competitive pressure, pass the savings on to them, for example under the form of lower costs charged for the performance of the

32 The risk, current or perspective, that capital or returns diminish because the standing of the intermediary worsens in the eyes of its stakeholders (clients, counterparties, shareholder, investors, authorities).

33 Translating the words of Costi (2007), it is a strategic choice allowed by the legal order. Its desirability is also stressed by Boatright (2000), 205.

34 White (2004), p. 2; Poser (1988), p. 98.

35 Respectively, costs advantages a firm can obtain when it expands its scale of operations and the costs advantages allowed for by the synergies arising from the provision of different services.

36 Poser (1989) p. 98.

37 Kroszner and Rajan (1997), p. 482.

38 Following Roe (1990) and Petersen and Rajan (1994) this is particularly important for small firms, for which access to the market should be facilitated. Drucker and Puri (2005), Yasuda (2005), Bharath, Dahiya, Saunders, and Srinivasan (2007): they all show that issuers prefer to obtain underwriting services by banks already providing them with lending services, although they do not agree on how strong the preference is. Not surprisingly, the studies on the benefits of integration have mostly concerned lending and underwriting businesses: they were undertaken to respond to (and contest) the regulatory choice of the Glass-Steagall Act. Nevertheless, the same considerations easily apply to other services.

39 Anolli, Banfi (2007), p. 428.

services[40]. Non-firm clients dealing with a firm which can offer a vast range of financial services are better granted "an integrated approach to their financial needs"[41].

If all this holds true, savers are more willing to put their savings in the market and businesses are thereby better able to finance their activities at a lower cost. Thus, the economy considered as a whole is benefited[42].

But what can be said about the issue of conflicts' exploitation? True is that the removal of all conflicts of interest is unfeasible, even in firms performing only one service for one client: for example they can give precedence to their interest simply by undertaking an unjustifiable number of transactions for the sole purpose of gaining more commissions. Also, and counter-intuitive as it might seem, to some extent multifunctionality is likely to work as a safeguard against exploitation. Consider the case of a firm willing to sell its services at all costs: where the financial institution can offer many products, "it is more likely to offer the product that is relevant for a particular customer"[43].

Moreover, scholars pointed out that that the information problem is mitigated in multi-functional intermediaries, which have "greater incentives to match customers correctly to products", and therefore "always provide reliable information and charge higher prices than specialized banks"[44]. Lastly, as CESR notices, even requiring disaggregation for businesses within the same firm, conflicts of interests could be avoided only at the cost of prohibiting group participation[45].

Still, one can not argue that with multifunctionality the problem of exploitation is irrelevant. The question whether MiFID has duly taken into consideration this when adopting the market-oriented solution of allowing multifunctionality will be addressed in the next chapter.

*II.2.1.2. Introduction of new services.*

A compared to the ISD, MiFID introduces new core (so-called investment services and activities) and non-core (so-called ancillary) services, all of which are subject to the conflicts of interest's regulation. It is worth it reporting the list:

The investment services and activities are (nn. 1-7 of Annex I, Section A)[46]:

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[40] Klein, Zoeller (2003), p. 10. Drucker and Puri (2005) have acquired evidences that when lending and underwriting are integrated, banks charge lower commissions for placements and require lower interests rate on loans. Indeed, these results hold for the US where, at least back in 2005, the industry featured a high level of competition.

[41] IOSCO (2007), 3.

[42] Following Roe (1990), multifunctionality can also improve the quality of corporate governance exercised by investment firms on their portfolio companies.

[43] Mehran, Stulz (2006), pp. 11-12. Nevertheless, as these Authors point out, not all products might be equally profitable … [and] integrated banking, by itself, can only resolve the conflicts of interest when margins are similar across products".

[44] Bolton, Freixas, Shapiro (2004), pp. 2, 4.

[45] CESR (2004a), p. 40.

[46] Reference to specific articles are to be understood as reference to the L1 Directive, whose art. 4 contains definitions.

- reception and transmission of orders in relation to one or more financial instruments, which leaves to the firm a limited operativity, meaning that it simply routes the orders it receives to a third party for its accomplishment;

- execution of orders on behalf of clients. Also in this case the firm has limited discretion, being bound by the order autonomously given by the investor for its execution, and simply acting to conclude arrangements on behalf of clients (art. 4 (1) n. 5).

- dealing on own account, i.e. the trading against proprietary capital (art. 4 (1) n. 6), which can match the investment to be accomplished for the client;

- portfolio management, through which the firm receives funds with the task of managing them through accomplishment of investments. The firm benefits from discretionary powers but is bound by the objective of tailoring the portfolio on the individual client;

- investment advice or, in other words, the provision of personal recommendations upon request or at the firm's initiative, in respect to one or more transactions relating to financial instruments (art. 4 (1) n. 4);

- underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis: this service is provided to firm-clients, and implies that the intermediary guarantees the sale of an issuance by purchasing it at a stated price from the issuing corporation; thus, the intermediary acquires a own position on the issuance;

- placing of financial instruments without a firm commitment basis: with respect to the previous case, here the investment firm does not acquire an own position, but intermediates between the issuer and the final investors putting its best effort to ensure placement;

- operation of Multilateral Trading Facilities, i.e. a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments, in accordance with non-discretionary rules (art. 4 (1) n. 15).

Ancillary services are (Annex I, section B) are, among others:

- advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings (n. 3);

- investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments (n. 5);

- services related to underwriting (n. 6).

MiFID has also introduced what is called 'systematic internalisation', which is not a new service but the sum of the services of dealing on own account and execution of clients' orders.

All the named services fall within the scope of the Directive only when they concern the financial instruments listed in Annex I section C MiFID[47].

As compared to the ISD, MiFID 'shifts' the provision of investment advice from the non-core to the core services; introduces the operation of multilateral trading facilities among the core-services; includes investment research and financial analysis among the non-core services.

These differences increase compliance costs on firms: intuitively enough, the more the activities, the higher the compliance costs, since conduct of business rules apply to all of them. What about potential benefits? Are these benefits related to the problem of conflicts of interest exploitation?

I will specifically address the issue of investment research, systematic internalisation and multilateral trading facilities in chapter V. Here, I should therefore concentrate on the new core service of investment advice.

The provision of advice is a powerful engine for intermediaries willing to exploit conflicts of interest. Investors, and especially retail ones, which suffer from extensive information asymmetries and bounded rationality often turn to intermediaries to decide whether and how to invest. Indeed, intermediaries stand out to the clients as having superior information about the market, the financial instruments, the potential for investments. The same information asymmetries taint the relationship between intermediaries and clients, which are not on the footing of verifying whether the advice received is unbiased.

Hence, intermediaries have both the opportunity and the motive to use advice at the expenses of clients. By advising investors to do so, they can sell their services, even where this is not justifiable from the investor's point of view. They can convince clients to choose the services which brings more revenues to the firm or its group; invest on instruments which are not suitable for their financial needs where this investment brings a gain or avoids a loss to the firm.

By shifting advice to the category of core services, the L1 Directive has rendered all conduct of business rules applicably to this services, despite maintaining the rule following which some conduct of business rules are not applicable to ancillary services (art. 19 of the L1 Directive which substantially mirrors art. 11 of the ISD), without the problems this could entail in the provision of advice.

Another effect realised is that investment advice can only be performed by investment firms and banks, hence strictly regulated entities in terms of capital endowment, ongoing supervision etc.[48]. Clearly, the instances of investors' protection have been put before the need for competition in the investment advice's market.

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[47] Such list is expanded as compared to that of the ISD, to take account of the new instruments whose importance has risen in the practice of the players on financial markets: for example, it now includes derivative contracts of the most diverse type (relating to a number of commodities, to climatic variables, freight rates, allowances or inflation rates or other official economic statistic, assets, rights, obligations and indices), derivative instruments for the transfer of credit risk, financial contracts for differences.

[48] Undertakings which are not legal persons are equalled to investment firms provided that their legal status ensures a level of protection for third parties' interests equivalent to that afforded by legal persons, and that they are subject to equivalent prudential supervision (art. 4 of the L1 Directive).

*II.2.1.3. Enhanced harmonisation.*

MiFID regulation was devised as a result of a new approach, known as Lamfalussy. Under this approach, rules are elaborated in four steps. Level 1 represents the 'foundation' of the intended framework and it is designed through Directives and Regulations. Level 2 Directives and Regulations contain detailed technical implementing measures of different nature and extent, depending on how the level 1 framework is constructed. CESR[49] manages level 3 with the purpose of ensuring that the level 1 and level 2 rules are uniformly interpreted and applied throughout the Community[50]. Indeed, where the level 1 and level 2 measures do not provide for a complete set of rules, member states retain a margin of manoeuvre, albeit following CESR's coordination. At level 4, the Commission intervenes for strengthening the enforcement of community law[51]. The result is a highly detailed regulation with CESR playing a central role in coordinating states, which can be described as a *de-facto* maximum harmonisation.

From firms' point of view, it should be irrelevant whether the costs of compliance are borne because the full set of applicable rules are devised at the supranational level, instead of at the national level. This at least as long as they do not aim at acting cross-border. When the provision of services beyond national borders is envisaged, then a levelled paying field is desirable, since it abates costs of acting in different jurisdictions. Thereby, it supports the process of integration which market forces can start but not accomplish themselves. As a consequence, more competition should be allowed for. This goes to the benefit of clients, which can obtain services from different providers, possibly competing on price and quality, irrespectively to whether they move cross-border to obtain investment services[52].

The drawback of *de facto* maximum harmonisation is indeed that if the intervention is not accurate, no regulatory competition can correct it: the maximum harmonisation does not allow for deviations, and hinders the application of the public good safeguard. Also, harmonisations partly contradicts 'accuracy' understood as the ability of the regulation to address features (for example investors' savings and investing patters) which are nation-specific.

*II.2.1.4. Home/host competences.*

MiFID has introduced the Host State competence on conduct of business rules: art. 32(7) mandates that "the competent authority of the *Member State in which the branch is located* shall

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[49] Under the Lamfalussy approach CESR advices the Community as to the content of the level 1 and 2 measures, and has a central role in ensuring that they are uniformly interpreted and applied throughout the Community. For this purpose, it issues administrative guidelines, interpretative recommendations, common standards, peer reviews, comparisons of regulatory practice recommendations which do not make part of the European legislation and do not require any legislative action from the part of member states.

[50] For this purpose, CESR issues administrative guidelines, interpretative recommendations, common standards, peer reviews, comparisons of regulatory practices. They do not make part of the European legislation and do not require any legislative action from the part of member states, but should entail a moral suasion effect.

[51] Committee of Wise Men (2001).

[52] As mentioned *supra*, I.4.3. clients, and retail ones in particular, present a strong bias toward national operators, or foreign ones which have a 'brand' in their own jurisdiction, for example because they have set up branches there.

assume responsibility for ensuring that the services provided by the branch within its territory comply with the obligations laid down in articles 19, 21, 22, 25, 27 and 28 and in measures adopted pursuant thereto"[53].

The host State's competence is justifiable in consideration of the fact that its "authority is closest to the branch and is better placed to detect and intervene in respect to infringements of rules governing the operations of branches"[54]. In addition to this, "host State … control is superior insofar as violations of rules of conduct are frequently referred to the competent authorities only on complaint by investors who have been defrauded or abused" and, since transactions are ruled by both "public law norms for supervisory purposes and private law duties", "only host State control can ensure that one single act of misconduct will be judged by the same set of rules by a regulator and a court in a civil proceeding"[55].

The new home-host allocation of competences does not completely eliminate two problems which arose under the ISD. First, there still might be some uncertainty as to the boundaries between prudential and transactional rules[56]. For this reason, CESR has suggested that States agree: where the line should be drawn between organisational and conduct of business requirements; that the home regulator asks the firm questions on organisational matters sent by the host regulator; that firms provide a defined set of common information on organisational matters to both regulators[57].

Second, more than one set of national rules are still applicable for businesses conducted on different territories and with clients which are nationals of different States; nevertheless, the current degree of simplification is considerable: under the ISD firms had to comply with as many national conduct of business rules as the number of clients of different nationality, whereas they are now only bound by the home State rules (in case of free provision of services), or by the rules of the countries where they have a branch, irrespectively to whom they conduct their business with.

The aforementioned simplification is not hampered by the wording of art. 32 (7) of the L1 Directive, which only entrusts the host State with the responsibility of enacting (and supervising) conduct of business rules with respect to the services provided by the branch *within its territory*. The article does not univocally clarify which rules are applicable where a branch offers services to clients which are national of a third Member State, and one could reach the conclusion that the conduct of business rules of any State in which a client is located are called upon. On the contrary, the European Commission has made clear that "any cross-border operation through a branch outside the territory of the Member State in which this branch is located is a provision of services by the investment firm and not by the branch as a separate legal entity"; thus, a free provision of services under art. 31 from the part of the firm itself[58]. It follows that the competence of the

[53] The named articles refer to the duty to act honestly, fairly, professionally, to the information duties, to the suitability, appropriateness, best execution and reporting obligations, to the client order handling rule and the pre- and post-trade disclosure duties for systematic internalisers.
[54] CESR (2006), p. 3.
[55] Köndgen (1998), pp. 125-126.
[56] "Whilst on paper 'organisational requirements' are reserved to the home regulator, the distinction between the system and controls environment for a branch and the way in which the business is conducted may not be a clear one": CESR (2006), p. 9.
[57] CESR (2006), pp. 11-12.
[58] European Commission (2007a).

Member State of incorporation is called upon and only two national rules remain applicable[59]: either that of the home State, or that of the branch, without the multiplications known under the ISD.

Nevertheless, this solution does not go uncriticised: it calls upon the home State's competence even for matters where art. 32 (7) would normally ground the competence of the branch State (if the service did not involve a third country). Some commentators emphasise that from a policy perspective it would be better to apply the regulation of the host State, this latter being in the end entrusted with the monitoring and supervision of the business of the branch on its territory[60].

*II.2.2. Conflicts of interest-related innovations.*

MiFID is the first piece of regulation which: closely looks at the nature of conflicts of interests; fully analyses their breadth; attentively identifies the incentives to their exploitation[61]. It makes clear that investors' interests may conflict with those the firm both on a stand-alone basis and as part of a group[62], as well as with those of certain persons connected to the firm or the firm's group.

The situations relevant for identifying the existence of conflicts of interest are those in which the firm or its connected persons: can make a financial gain or avoid a financial loss at the expenses of clients; have a own interest in the outcome of the service provided and distinct from the client's one in that outcome; also serve another – more important – client, whose interests become the firm's priority at the cost of disregarding other clients' interests[63]; receive from a third person inducements other than the standard commissions or fees for that service; carry out the same business as the client[64].

Conflicts of interest are both potential conflicts, and actual conflicts. The former mainly depend on how the firm is organised, and should be managed to the maximum extent possible through organisational devices; beyond that, the conflicts become 'actual', and firms should not exploit them. It is nevertheless not sufficient that "the firm may gain a benefit if there is not also a possible disadvantage to a client, or that one client to whom the firm owes a duty may make a gain

[59] CESR (2006), p. 10 talks about branches' "dual supervision".
[60] Penn (2007), p. 23.
[61] Sectoral definitions can be found in: Directive 85/611/EEC of 20 December 1985 (on UCITS), O.J. L 375/3 of 31 December 1985, amended by Directive 2001/107/EC of 21 Jan. 2002, O.J. L 41/20 of 13 February 2002; Directive 2003/6/EC of 28 January 2003 (on insider trading and market manipulation), O.J. L 96/16 of 12 April 2003; Commission Directive 2003/125/EC of 22 December 2003 (on investment recommendation), O.J. L 339/73 of 24 December 2003.
[62] See for ex. recital 27 of the level-2 Directive's preamble.
[63] Art. 18 (1) MiFID; recital 24 of the level-2 Directive.
[64] CESR (2004a), p. 43, indicates as a way of example the case in which the firm performs dealing on own account. This case would call for a better identification by CESR, following Onado and Sabatini (2007), p. 82, and is misleading for Fusetti, Recine (2007), p. 164: as they argue, the fact that the firm acts in the same market as the client does not necessary go to the detriment of this latter, insofar as the intermediary acquires a particular expertise thereof, which uses to better serve investors' interest.

or avoid a loss without there being a concomitant possible loss to another such client"[65]. Although 'exploitation' is not clearly defined, it is possible to infer that it amounts to the breach of duties the firm owes to its clients in one of the abovementioned situations.

MiFID does not clearly state what clients' disadvantages should be relevant for the purpose of identifying possible conflicts of interest; by the same vein, it does not explain the meaning of the expression 'at the expenses of clients'. Without any doubt, though, the regulation does not aim at shifting the risks of acting on the financial markets on the intermediary. The fact that such risks are borne by the investors is inherent to the firm-client relationship, so that firms do not have either to prevent not to avoid them. But this only holds true insofar as the investment decisions are taken on the basis of the client's informed self-determination, and the losses merely trace back to the markets' volatility. Losses beyond that, due for example to the firm advancing other interests by breaching its duties, should be shielded by the regulation[66].

The importance conferred to the concept of damage and loss to the client, should not be interpreted as a sign that MiFID makes enforcement conditional upon the existence of any such loss. As we will see later, Authorities' should intervene irrespectively to it; this tells us something about the regulator's approach to conflicts of interest as a means of not only protecting the clients but also the markets. Whether this solution is cost-effective will also be later enquired upon.

Putting together the list of services described above, and the definition of conflicts of interest just mentioned, it is possible to more closely look at the number of conflictual situations arising in the course of intermediaries' businesses.

Each service entails peculiar conflicts of interest, which also depend upon whether the firm acts for one or more clients at the same time.

The simplest case arises where the intermediary performs only one service for only one client: the provision of services generates commissions, which correspond to the intermediary's interest laying at the at the heart of the business activity. Where it is clear that the customer shouldn't be "victimized by the fact that the seller's objective is to benefit as much as possible from the transaction"[67], she is indeed exploited insofar as the firm decides to offer its services "at all costs". The firm might for example undertake for an investors a number of operations on her portfolio which has no justification other than the willingness to gain more commissions (a case which is known as churning).

A larger degree of complexity comes into play where the investment firm also contextually undertakes other activities on own account. For example, where the intermediary has a proprietary position on financial instruments[68] and these are performing badly, firms providing clients with individualised managements could dump the instruments in the clients' portfolios and avert a loss easier than what could be possible by offering the instruments on the market[69]. Also, the firm can

[65] Recital 24 of the L2 Directive. See also arts 18 of the L1 Directive and 21 of the L2 Directive. The aim of safeguarding clients' assets is stressed by Fusetti, Recine (2007), p. 164.

[66] Strictly interpreted, this would mean that firms should only detect the situations in which they might breach conduct of business rules, which is not particularly effective as a definition of conflicts of interest: it mixes up conflicts with their exploitation and, above all, would require a beforehand admission from the part of the firm as to the cases in which it will breach the rules.

[67] Mehran, Stulz (2006), p. 5.

[68] For a further description of conflicts in this case see Onado, Sabatini (2007), p. 60.

[69] Also: "when the banking institution has a 'salesman's stake' in promoting products or services while at the same time purporting to provide disinterested or objective advice. For example, the banking institution or its

operate on its proprietary position on the knowledge it has about clients orders: it can sell before executing the client's big sell order, in order to avoid that the consequent downturn of the investment's value does not affect its portfolio; it can buy before executing the large buy order to profit from the upwards shift in price. These cases go under the name of front-running[70]. The reason why they substantiate a conflicts of interest exploitation is that when the client is willing buying, she will only be able to do it at the higher price determined on the market by the previous buy order of the firm, and when she is willing to sell, the proceedings she will able to make are decreased by the previous sell order posted by the firm. Such behaviour normally happens with big (professional clients') orders due for immediate execution[71]. With small individual (retail) orders, the investment firm is not likely to gain sufficiently from the exploitation. Nevertheless, the same as with professional clients can happen when the firm gives the same buy advice to a sufficient number of (even) small clients.

Other cases of exploitation arise when the firm cumulatively performs two services for one client. It can advice the client to deal on instruments it has in its portfolio and wants to dismiss, or on instruments which are issued by another company of its group. In brief, when financial advice is coupled with other services, the potentials for exploitation are immense, and this holds true for both natural persons-clients, and firm-clients, which could be advised to undertake a securities offering, although other forms of funding would be more desirable (but less remunerative for the intermediary)[72].

Other conflicts can be exploited where the intermediary contextually serves two different clients with investment or other services. Where the bank has a lending business with an issuing firm it will be worth it to place its instruments in the clients' portfolio, so that the loan is more secure[73].

The same happens where the intermediary performs more investment services, regardless to whether it performs the same or different services to each client. In these cases, conflicts of interest root in the firm-client relationship: when one client is favoured in terms of worthiness of the business it provides to the firm, its interests are likely to be put before those of the other client. For example, where the firm is dealing on two different clients' account, it can disrespect the time priority of orders, and execute those of the preferred client first. Something similar happens where the firm provides different services to different clients, for example the services of underwriting and placement, for a firm-client, and the service of portfolio management and/or investment advice for retail clients: it can ensure firm-client's satisfaction by aggressively backing the purchase of its issuance.

In the underwriting with a firm commitment basis, the intermediary is bound to take up all unsold securities, and could therefore "use its managed funds as a dumping ground for newly issued securities that are hard to place"[74]. In so doing, the intermediary fulfils two interests

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employees could abuse such a situation by … advising customers for the purpose of assisting the bank's own trading, [or] marketmaking": GAO (1989), p. 10.

[70] See Boatright (2000), p. 211.

[71] Consob (2007), 84.

[72] IOSCO (2007). Nevertheless, if it does not perform the other – more suitable – service, it is normally held that the intermediary has no duty to advice the customer to resort to other competitors.

[73] Beltrami, (2007), p. 337. Mehran, Stulz (2006), p. 8. Annunziata (2004); Onado (2003). This type of conflict stays at the boundaries between the regulation of investment services and that of banks' governance, which should control for attentive evaluation of banks' lending exposure.

[74] Mehran, Stulz (2006), p. 8.

conflicting with those of investors: the issuers' interest of placing the securities, and its own interest of not retaining an excessive portfolio on a single issue, or not engaging too many funds on unprofitable securities. This case differs from the one above only insofar as the intermediary has two interests which contradict that of the client. One is directly a firm's interest; the other becomes indirectly the interest of the firms, being the interest of its preferred client.

As it was under the ISD, two tools are deployed against conflicts of interest: organisation and information. Next to this latter, the problem of conflicts of interest is addressed imposing intermediaries other conduct of business rules, to be applied proportionally to the need of protection of different clients. Client's categorisation, and the level of protections each class of clients should be granted are all specified within the supranational regulation[75].

This more detailed consideration of what constitutes a conflict of interest was surely necessary in some Member States. The case of Italy is emblematic.

Under the pre-MiFID regulation of TUF[76] and its Consob's implementing measures (regulation 11522)[77] this matter was overlooked.

Art. 21 TUF laid down the general principle of diligent, fair, transparent behaviour of the intermediaries, which were bound to act in the interest of the clients and the integrity of the market[78].

The gaunt 2005 TUF's provisions were enacted by Consob with regulation n. 11522. Pursuant art. 26 intermediaries had to: act in an independent way, coherently with TUF's principles; avoid any behaviour which could benefit a client at the expenses of another one; promptly execute clients' orders; gain knowledge of the financial instruments and services, adequate to the type of service provided; act so that costs on clients are limited, and each service can offer the best possible result, also in the light of the risks the investor is willing to bear (para 1, lett. a), c)-f)).

Specific rules on conflicts of interest were contained in art. 27 of the 11522 Regulation, which applied to all services[79] provided to retail clients (art. 31 (1)). It required firms to monitor all direct and indirect conflicts, but only limitedly clarify what should be understood under the concept of conflicts of interest: reference was made to group links, cumulative provisions of more than one services, own or group's business activities beyond the provision of services.

The lack of a clear definition as to what should be considered a conflict of interest heavily diminished the bite of the decisions adjudicated by courts.

For the dealing on own account: where it was found that the firm had executed the service by selling instruments from its own portfolio, most judges held that no conflict of interest could

75 Clients are divided into three categories: retail, professional, qualified counterparty depending upon the level of sophistication. See *infra* VI, especially VI.2.1.2. and VI.2.2.. The general principle that investment firms have to act honestly, fairly and professionally and that clients' interests have to be accorded supremacy over firms' ones (art. 19 (1) L1 Directive) applies to all three classes of clients (recital 25 of the L2 Directive's Preamble).

76 Legislative decree n. 59 of 1998. I will refer to its 2005 version. Afterwards, TUF has undergone a number of amendments which have been repealed or re-adjusted and are not relevant to this reasoning.

77 Of 1 July 1998 available at www.consob.it.

78 The article also seemed to imply that the existence of conflicts of interests is not a given, and that they are only to a small extent unavoidable.

79 Safe for what will be said below for portfolio management.

arise, under the condition that the dealing had taken place as a consequence of the client's order[80]. All judges hinted – if not openly stated – to the fact that the order should be given explicitly by the client, without the firm's interference. They nevertheless tended to presume that the order was given spontaneously, unless otherwise proven.

It was also clear that when the firm was placing securities from its own portfolio which it nevertheless acquired on the market only after the client's order, the risk of conflicts' exploitation was even lower[81]. Surprisingly, though, the acquisition from the portfolio of another group's company was equalled to the acquisition on the market[82]. The fact that, as widely recognised, the securities in question where at high default risk did not change the perspective[83].

Courts also held that the existence of previous lending relationships between the intermediary and the issuer could not lead to a conflict of interest between the intermediary and the client subscribing the issuer's instruments[84]. This solution was backed by a Consob's interpretative act, which held that if a lending relationship were to be considered as giving rise to conflicts of interest, all major Italian banks would have to warn clients about the existence of conflicts of interest in the course of any dealing taking place on Italian issuers' securities. The unwanted consequence would be the loss of value and significance of the communication in the eyes of the investors. By this, the Authority did not exclude that, on a case-by-case basis, court could find the existence of conflicts. Nonetheless, it held that no such conflict could ever arise if the lending business is undertaken with another company of the group to which the issuer belongs[85].

The existence of conflicts of interest has been rarely affirmed. In most instances, courts have exclusively took cognisance of what intermediaries already declared to their customers[86].

As compared to the previous Italian regulation, and in light of the difficulties Italian judges were facing when ruling on the matter of conflicts of interest, MiFID has ameliorated the definition of conflicts of interest and the identification of the cases which should be considered relevant. For example, drawing from the cases above, after MiFID it is difficult to deny that an intermediary who has lent to an issuer has an interest in the outcome of the services through which the securities of the issuer are allotted to investors.

**Conclusions.**

[80] Tribunals of: Catania of 23 January 2007, Genoa of 8 and 16 May 2006, Milan of 26 April 2006 and Trani 7 June 2005.

[81] Tribunals of Mantova, 5 Aprile 2005 and Parma, 16 June 2005.

[82] Tribunal of Mantova, 18 March 2004.

[83] Maffeis (2008), p. 455.

[84] Tribunal of Parma, 16 June 2005. Tribunal of Rome, 8 October 2004 and 11 March 2005. Especially if the intermediary does not participate to the syndicate set up for the placement of the issuance: Tribunal of Catania, 23 January 2007. But the Tribunal of Venice, Pitteri e Klamer c Deutsche Bank, of 22 November 2004 has stressed the high risk of exploitation inherent to the situation in which the intermediary performs for a firm the service of placement on a commitment basis.

[85] This principle was then applied by Tribunal of Monza, 16 December 2004.

[86] Tribunal of Florence, 19 April 2000: R.R. c Banca Toscana, available at www.ilcaso.it/giurisprudenza/archivio/TFI-AP-19-04-05.htm. Tribunal of Taranto, 27 October 2004. See also Tribunal of Parma, 22 September 2004.

This Chapter has analysed MiFID as compared to its forerunner, the ISD. The aim was spelling out both the general and the conflicts of interest-related innovations relevant for the next parts of the work.

Among the general innovations – which contribute to the creation of a completely new framework under which investment services are provided – it is worth it mentioning: the firms' multifunctionality, which multiplies the instances of agent and common-agent set-ups; the introduction of new services, which has importantly shifted investment advice from the realm of non-core services, to that of core services, thereby rendering a number of conduct of business rules applicable; the enhanced harmonisation, which aims at abating costs for firms acting cross-border while ensuring a common level of investors' protection; the new allocation of Home/Host States competences, whose aim is (also) that of rendering control over firms' behaviours more effective.

Concerning conflicts of interest, MiFID considers for the first time their nature and breadth, and the incentives to their exploitation; on this basis, I have concretely analysed how and when conflicts might arise. This clarification was indeed needed, and I have argued it with special reference to the Italian pre-MiFID regulation and the case-law which was devised on its basis.

# Chapter III.

## MiFID's Regulation on Conflicts of Interest. Its Two Regulatory Pillars.

As it was under the ISD, MiFID's regulation against the exploitation of conflicts of interest rests on two pillars: organisation, on the one hand, information on the other. Summarising their interaction: intermediaries should be organised so as to be able to identify the conflicts which might arise in the light of their actual level and type of business and to manage them to the maximum extent. They should inform investors about the remaining, possibly detrimental, conflicts, in order to put them on the footing to take an informed decision and express their informed consent.

Let us more closely analyse the way in which these two regulatory pillars are deployed and interact.

### III.1. Organisation.

In the background of the European regulation lays the idea that firms' organisation is a fundamental entrepreneurial choice, which should be left free in order to grant the highest potential for efficiency and competitiveness. As a consequence, intermediaries multifunctionality is allowed. Since multifunctionality leads to the multiplication of conflicts of interest, MiFID has accepted them as unavoidable[1]. Nevertheless, the legislator has also clear in mind the fact that some safeguards are needed in order to ensure that investors are not harmed by the autonomously chosen organisation, and conflicts of interest are not exploited.

Art. 5 (1) of the L2 Directive lays out the general organisational requirements: firms have to ensure that their personnel features "skills, knowledge and expertise necessary for the discharge of its responsibilities" (lett. d)), which in turn have to be clearly stated (lett. a)). Relevant persons have to be made "aware of the procedures which must be followed for the proper discharge of their responsibilities" (lett. b); their sound, honest and professional performance of functions shall not be hampered by organisational set-ups. Art. 6 of the L2 Directive requires firms to "establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the firm to comply with its obligations … as well as the associated risks, and put in place adequate measures and procedures designed to minimise such risk and to enable the competent authorities to exercise the powers effectively".

The control over firms' organisational adequateness should be realised at two levels: within the firm, by means of internal control mechanisms supervised by the internal audit function (so-called line controls); externally from the firm, by virtue of the supervision exercised by authorities and the monitoring of clients.

[1] CESR (2005b), pp. 40 ff.: intermediaries have no duty "to prevent conflicts of interest from arising". See Boatright (2000), p. 201 and Fusetti, Recine (2007), p. 159.

Firms should have in place (and maintain) internal control mechanisms i.e. policies and procedures which, proportionally to the nature, scale and complexity of the business, ensure that they comply with their obligations. Their adequateness and effectiveness should be monitored by a permanently-established compliance function, which also advises and assists the persons responsible for carrying out investment services and activities[2]. Setting up a compliance function appears to be mandatory, but the rules on its functioning might vary depending upon the needs of each firm. Next to this, the senior management is also required to ensure that the firm complies with its obligations under MiFID. For this purpose, it should assess and review the firms' policies and arrangements and take the measures necessary to address deficiencies. Lastly, but only where appropriate in the light of the firm's complexity, the supervisory function should share the tasks with the senior management and an internal audit function should be set-up. This latter should evaluate the adequacy and effectiveness of the internal control mechanisms and issue recommendations on this matter (arts 13 of the L1 Directive, 5 (1) lett. c) and 6-9 of the L2 Directive).

(Home State) authorities can exercise their control over firms' organisation in general when issuing the authorisation for the performance of investment services: pursuant art. 7 (1) and (2) and art. 16 (1) of the L1 Directive national authorities shall be provided by firms with a programme of operations setting out, *inter alia*, the organisational structure and shall not grant authorisation unless they are satisfied that it is adequate to meet the obligations under the European Regulation.

Despite addressing the proper setting up of the business in general, these provisions also touch upon the problem of conflicts of interest.

Recital 29 of the L1 Directive and art. 13 (3) of the L1 Directive require firms to identify the conflicts which might arise in the conduct of their business and choose the organisational arrangements allowing for their management.

For the identification of conflicts, intermediaries should take into consideration the whole range of activities they perform[3], both as stand-alone firms and as firms making part of a group[4], and the interests they give rise to, with special reference to their relevant persons (art. 18 (1) of the L1 Directive and Recital 24 of the L2 Directive).

The identification process requires firms to consider, as a minimum standard, whether the firm itself, or its directors, partners, managers, tied agents, employees, natural persons placing services under the control of the firm[5], or persons having a relevant direct or indirect control link

[2] Preconditions to the correct performance of such function are its permanence and independence: it must have authority, resources, expertise and access to relevant information; a compliance officer must be appointed; persons involved in the function must not be involved in the performance of other services and activities and their remuneration shall not hamper their objectivity. See also Biasin (2007), p. 390.

[3] Including their non-investment services businesses, such as lending: CESR (2004a), p. 40.

[4] As defined by art. 2 n. 5 of the L2 Directive. A group is formed by a parent undertaking, its subsidiaries and the entities in which the parent or the subsidiaries undertakings hold a participation, as well as the undertakings linked to each other by some other relationships (having unified management pursuant the terms of a contract or of the provisions of the memorandum/articles of association; sharing the majority of the persons in the administrative, management or supervisory bodies) which triggers to duty to draw up consolidated accounts in the light of article 12 (1) of Council Directive 83/349/EEC (Directive of 13 June 1983, published in Official Journal L 193 of 18 July 1983, 1, lastly amended by Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006, Published in Official Journal L 224 of 16 August 2006, 1).

[5] This list summarised the concept of relevant persons defined in art. 2 n. 3 of the L2 Directive.

to it: i) might realise a financial gain or avoid a financial loss at the expenses of a client; ii) have an interest distinguished from the client's one in the outcome of the services provided or of a transaction; iii) have a financial or other incentive to favour the interest of another client or group of clients; iv) carry out the same business as the client (art. 21 of the L2 Directive).

Among the conflicts identified, those entailing a material risk to damage the interests of one or more clients should be 'managed'. Firms are left free to identify the management measures, albeit having to ensure that those chosen are appropriate to the size and the organisation of the firm, the nature, scale and complexity of its business and allow relevant persons to carry out their activities at an appropriate level of independence.

To attain this aim, firms should be organised as to: prevent or control the exchange of information between relevant persons; prevent or limit the possibility that any person can exercise inappropriate influence over the carrying out of services and activities; prevent or control the simultaneous or sequential involvement in different activities, when this contradicts the proper management of conflicts of interest; ensure the separate supervision of relevant persons whose principal function involves the carrying out of activities on behalf of, or the provision of services to, clients whose interests may conflicts, or who represent different interests that may conflict; remove any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity when the activities might entail a conflict of interest.

This list summarises what firms should attentively have regard to, but might well be either insufficient or over-inclusive in light of the individual firm's business activities or structure. If this is the case, firms should enact more or less stringent safeguards (arts 13 of the L1 Directive and 22 of the L2 Directive).

The need for "procedures to prevent or control the exchange of information between relevant persons engaged in activities involving a risk of a conflict of interest" has been read as a clear indication that firms should set-up Chinese walls, i.e. organisational, if not physical, barriers among departments, arms or areas of an investment firm, entrusted with different tasks[6]. Indeed, Chinese walls also appear to be effective in order to separate the supervision of relevant persons[7]. The walls serve the same aim of avoiding information outflows as the rules prohibiting sequential involvement of the same person in different activities do[8].

The rules on separate supervision, avoidance of external influence, independent remuneration systems ensure that the behaviour of an employee vis-à-vis the client is not biased by pressures coming from outside the relationship in general, and by career or remuneration concerns of the employee, in particular.

Importantly, the list is able to capture the problems inherent to both the agency and the common-agency set-up[9]. Against the (agency) threat that the firm favours its interests above those of the clients, MiFID requires that the information which could convey knowledge as to the

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[6] CESR (2004b), p. 9 confirms that other measures are allowed, but Chinese walls constitute a benchmark for any other choice: "Chinese walls should not be mandatory, but other means should at least be as effective".

[7] Perrone (2007), p. 63, notices that the principle of separate supervision of relevant persons is highly innovative.

[8] Chinese walls are *de facto* mandatory: CESR (2004c) has pointed out that they constitute the benchmark for organisational measures, and firms are allowed to enact different measures if they are at least as effective as the walls.

[9] See *supra*, I.3.1.

existence of conflicting interests is circulated to the least possible amount. Against the (common agency) threat that the firm serves with preference some clients over others, the Directive disentangles the remuneration and the supervision of employees working in different departments. When these departments work with clients standing at the opposite site of the market (for ex. an issuer and a buyer of instruments), this aims at avoiding that one (in the example it would be the buyer, since the relationship with the issuer is far more remunerative) is not treated in a way which exclusively benefits the other. The prohibition of any inappropriate influence is a residual principle, which aim at avoiding, among other things, the possibility that the interests of one clients are sacrificed to those of another client, also when the two stand on the same side of the market (for ex. two retail clients using the brokerage activities of the firm).

The conflicts entailing a material risk of damage to clients' interests, as well as the measures implemented to avert this possibility, should make part of a firms' conflicts of interest policy i.e. a document which lays down in writing the circumstances from which conflicts might arise, and the measures consequently implemented. The policy shall explicitly mention those services and activities which appears to be more problematic, as named in recital 26 of the L2 Directive: investment research and advice, proprietary trading, portfolio management and corporate finance business, including underwriting or selling in an offering of securities and advising on mergers and acquisitions[10].

Control over the organisation's adequacy for the purpose of managing conflicts of interest can be exercised by authorities under submission of the conflicts of interest policy. This is not clearly stated by MiFID, but can be inferred by the wording of the L2 Directive (art. 22), stating that where the measures and procedures mentioned in the policy do not appear to be sufficient, Member States shall require alternative or additional measures.

Art. 23 of the L2 Directive requires investment firm to "keep and regularly update a record of the kinds of investment or ancillary service or investment activity … in which a conflict of interest entailing a material risk of damage to the interests of one or more clients has risen or … may arise". This record is filled in thanks to the monitoring activities which are required for the purpose of managing the conflicts by means of organisational measures[11]. Nevertheless, the relative purposes and importance of this record and the conflicts of interest policy are hard to assess. This provision, together with that mandating disclosure of the policy to clients upon request (art. 30 (1) (h) and (i) of the L2 Directive) would aim at rendering control and enforcement more effective. The mere presentation of the written policy shall not therefore become an easy way for intermediaries to avert all responsibility if the measures are concretely not efficient.

Making intermediaries' choice on organisation the first presidium against conflicts of interest normally attracts positive comments[12]. It appears to be a pro-competitive, flexible approach.

Emphasising competition means giving due consideration to the market constraints which can control the intermediaries' behaviour. Intuitively, competition is the result of any Directive which smoothens the cross-border provision of services, both by introducing a passport

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[10] I will specifically deal with them later …

[11] It also represents the basis for subsequent disclosure of the situations which could not be adequately managed. Fusetti, Recine (2007), p. 168, concede that this provision can burden firms with relevant costs, but still is of use for the performance of *ex post* control by national authorities.

[12] See for example FSA (2006d), § 9.4.

mechanism and by levelling the conduct of business and other rules to which market operators are subject.

But MiFID goes beyond that in its pro-competitive approach insofar as it regulates organisational duties, in particular where it leaves to intermediaries themselves the choice as to the level at which they can adopt the (costly) organisational and other requirements, flexibly allowing for any solution which seems coherent with the type and complexity of the businesses. A number of scholars have pointed out that more firms are granted entry than what would happen with requirements not taking into account what is practically and economically feasible for each business[13].

Business-led solutions have indeed the benefit of being enacted with closer insight of the problems peculiar to each firm, and can be more easily adapted to changing business conditions. All in all, they should foster the entry in the market, protect the firms' efficiency and consequently ability to remain in the market and compete, so that the industry itself would be able to exercise pressure on firms which do sufficiently protect investors.

Reliance upon firms' decisions on the matter of organisation is a path the international regulation has already gone down. The control over the setting up and ongoing management of such firms is a prerequisite for ensuring the soundness of the businesses, a crucial Authorities' aim. Lately, the regulation has adopted the view that this aim is not necessarily in contradiction with the entrepreneurial ones. On the contrary: as the Basel II Accord[14] makes clear, firms can be given the right incentives to identify an organisation which fulfils private and public aims at the same time. If this is true, firms can be accorded a greater margin of manoeuvre in the identification of the organisation which can adequately fit their specific needs without being prejudicial to the public objectives.

MiFID is coherent with the most recent national and supranational regulations on the matter of line controls (internal audit, compliance function, senior management) and Chinese walls.

Line controls are commonly described as indispensable tools for the "well functioning and transparent regulatory processes"[15]. Indeed, their direct link to the internal organisation of the firm puts them on a preferential footing for immediately detecting anomalies and suggesting remedial intervention, possibly before the situation causes an harm to individual investors or to the market.

As the Basel Committee on Banking Supervision stresses[16], before MiFID's transposition, Germany, the UK, Italy and France required an internal control function to assume responsibility

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13 AA.VV. (2002), p. 79. *Contra*, Perrone (2007), p. 66, who instils the doubt that there might be an over-deterrence in the fact that intermediaries risk to have their authorisation withdrawn because of non-compliance with the organisation duties pursuant art. 8 lett. c) of the L1 Directive. German scholars German scholars point out that the more conflicts a firm is not able to manage, the more conduct of business obligations it is bounded to. Hence, *ex ante* costs savings are off-set by *ex post* additional costs so that there is no competitive disadvantage for firms which deploy organisational measures against conflicts to a lesser extent: Koller (2003), Rn. 14-15, p. 1055; Scharpf (2000) pp. 26-27. Hopt (1975), pp. 425 ff.; Assmann, Schütze (1990), Rn. 37. AA.VV. (2002) *Handbuch der Compliance-Organisation*, p. 79.

14 Basel Committee on Banking Supervision (2004).

15 Directorate for Financial and Enterprise Affairs – Committee on Financial Markets, OECD (2008), 12. See also Fusetti, Recine (2007), p. 162.

16 Basel Committee on Banking Supervision (2008), p. 24.

for compliance to the regulation[17]. Outside the Member States' borders, this function is currently required – among others – in the US[18].

The importance of the compliance function was already recognised by CESR in its Standard 9 on Investor Protection, and by IOSCO, which suggested the setting up of "control rooms" within the compliance function for the overall review of the activity of the group[19]. This latter also took position on the tasks of the senior management: "Conflicts may in some cases need to be considered, in addition to the assessment by the compliance function, at a management level above the individual business unit or entity that has the relevant conflict". "One way for groups to identify and address conflicts … is to establish review, approval or central conflict management committees that comprise people with sufficient authority, autonomy and independence to take decisions uninfluenced by the commercial pressures of the relevant business units. … The committees should include personnel who are above the level of individual business entities, such as the chief compliance officer, head of internal audit, head of the legal division and independent board members if appropriate. If appropriate, the committee should also comprise senior representatives of those parts of the organisation that should be physically separated"[20].

What MiFID does, is to list the bodies entrusted of these controls and does not go into details on how they should be structured and or what their tasks and relative responsibilities are. It is therefore left to Member States to find the solutions which, coherently with their rules on business organisation, do not render the allocation of powers and responsibility excessively blurring[21].

Chinese walls were, even before MiFID, a recurring practice in a number of Member States, as well as in the US. In the UK they were among the instruments which the Financial Services Authority (FSA) considered appropriate to shield information which the intermediary should otherwise disclose to the client (Handbook (COB 2.4.). In Germany, § 3.3.1. of BaFin's Directive of 25 October 1999 explicitly mentioned Chinese walls, and scholars normally considered them the main organisational tool against conflicts' exploitation[22]. For the US, GAO stresses their role for shielding critical and confidential information, as well as for limiting inappropriate transactions between units[23].

The rule on separate supervision of employees of different arms, that on independence of remuneration structures and the general clause mandating avoidance of all inappropriate external influence, efficiently address the common-agency set-ups: employees who serve an investor

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[17] For Germany and the UK see Biasin (2007), p. 392 and Principle 8 Handbook, respectively.

[18] NASD and NYSE Rules require: members (and registered US investment advisers) to designate a chief compliance officer; broker dealers to designate a principal executive responsible for compliance. Banks' senior managers should designate specific individuals to exercise supervisory responsibility for the sale of some non deposit investment products. See also GAO (1989), pp. 18-19.

[19] IOSCO (2007c), p. 8.

[20] IOSCO (2007c), pp. 7-8.

[21] Solutions vary grandly across Member States. In Germany, for example, compliance is set-up on a consolidated basis, and then articulated on a geographical or divisional basis. The function is independent, but has to report to the *Vorstand* (Board of Directors), and in particular to a specifically designed member of it. It has the duty to set up informational barriers and to elaborate (and supervise) the processes in order to identify, evaluate, manage and monitor conflicts of interest, in line with the policies identified by the senior management. This holds true for both the acquisition of new clients, and the provision of new products and services (Biasin (2007), pp. 392 ss.).

[22] Kümpel, Veil (1996), p. 182. Cahn (1998), p. 41.

[23] GAO (1989), pp. 16-17.

should not suffer from career or remuneration concerns if they do not advise the client as it would be in the interest of the issuer, whose interest in pursued by the employees of the corporate arm of the firm. The named provisions are therefore necessary to disentangle incentives and lowering the motives of exploitation.

A number of MiFID's choices on organisation have nevertheless been subject to critiques[24]. The L2 Directive's definition of groups (art. 2, para 5) is one of them. This definition roots on the concept of hierarchical control (see *supra*, endnote 19). Nevertheless, the practice shows that some investment services are performed by means of business co-operations. One case is the consortiums created for securities offerings**.** In light of the extensive conflicts of interest which might arise, scholars have criticised the fact that that such co-operative forms are treated differently from a group in the legal sense, despite having "common business goals and concerted actions"[25]. Thus, they suggest that art. 22 (1), second paragraph of the L1 Directive referring to firms being members of a group be interpreted as encompassing firms acting together[26].

They also suggest to handle conflicts of interest problems within both groups and consortiums by setting up a central conflict management committee composed of representatives of the members having the capacity of compliance officers[27]. Its task would be that of identifying and evaluating conflicts, and developing recommendations to the members. For this purpose, they should have full access to information, act independently from management and exclusively report to the board of directors or compliance officers[28].

Chinese walls implicitly required by art. 22 of the L2 Directive address two situations: that in which the firm provides one service to one client having at the same time an own interest in securities; that in which the firm serves two different clients with two different services. Imagine the case in which the firm owns a portfolio of securities whose value is likely to deteriorate soon: the investment services arm of the firm, under the pressure of the brokerage arm, could advise its clients to acquire the named securities – or place them in the clients' portfolios.

Imagine the case in which the intermediary has a corporate arm underwriting a firm's issuance of securities: it could ensure the widest placement of the issuance insofar as the investment services' arm advises its clients to purchase those securities, or places them in the clients' portfolios. The incentives to act in the interest of the corporate arm might also increase if only the intermediary (or one of its group's firms) has a lending relationship with the issuer, whose deteriorating financial situation seriously hampers the possibility of receiving the loan back. In all these cases, Chinese walls should prevent the outflow of information between arms entrusted with different activities, and avoid that one acts on the knowledge, and to serve the interests, of the other.

My aim is showing that showing that the goodness of the mandatory creation of Chinese walls can be controversial if the aim is that of protecting investors[29].

When intermediaries sponsor an issuance they might have a two-fold interest in its widest subscription and, hence, in instructing the brokerage/management arm accordingly. That of

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[24] Presti, Rescigno (2007), p. 29, blame the European regulator for requiring firms to *de facto* enact a separation which it has not openly mandated.
[25] Kumpan, Leyens (2008), p. 93.
[26] Kumpan, Leyens (2008), p. 94. See also IOSCO (2007c), Final report, p. 9.
[27] Kumpan, Leyens (2008), p. 94.
[28] Bahar, Thévenoz (2007) p. 1, 13; Leyens (2006), p. 331.
[29] Lehar, Randl (2003), question this with reference to analysts. See *infra* V.3.

pursuing the issuer's interest in raising capital to the highest amount possible, which becomes the intermediary's interest in light of the profitable business relationship it can entrench (or conserve) thereafter; that of pursuing their own interest if they have lent to the issuer and their loan has become too risky in light of the deteriorating financial conditions of the firm.

The first type of interest can easily be inferred by brokerage/management arms' employees, since the information about the underwriting relationship either *de facto* or officially flows to them. For example, under Directive 2003/71/EC (Prospectus Directive, hereinafter: PD)[30], concerning the prospectus to be published when securities are offered to the public or admitted to trading, the intermediaries stand out to the public in many ways: they can be considered offerors, they have to take care of the publication of the prospectus, and bear responsibilities as to some of its inaccuracies[31].

Chinese walls are not required to shield information which is already deemed to be public and one would not be surprised that the intermediaries take advantage of the economies of scope inherent to the cumulative provision of both services. The intermediary is compliant with the duties inherent to the protection of clients' interests if it places instruments giving preference to those it underwrites, provided that the information publicly available allows to conclude that they are appropriate to the clients.

But between the underwriting and management arms asymmetries exist with respect of non-public information, in particular the former has a more thoughtful picture as to the issuer's financial situation. The same holds for the relationship between the lending arm – which monitors the quality of the loans accorded, and the arms which manage the investors' portfolios. The outflow of this type of information is nevertheless 'captured' by the setting up of Chinese walls.

This results in investors being offered financial instruments on the basis of information at disposal by virtue of other regulations (the prospectus, the periodic financial disclosure etc.[32]), which is processed with the expertise of the intermediary. If the expert is unbiased, it can more effectively help investors elaborate their preferences. For the expert to be unbiased, some knowledge has to be shielded, for example that on the worsening financial condition of the issuer to which the intermediary has also an outstanding loan.

Let alone that the European securities market (and the investors herein) are only apparently accorded a high amount of information, which should be tailored so as to enable investors to make an informed assessment of the situation and take decisions accordingly[33], the question is whether

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[30] Directive of 4 November 2003, published in O.J.E.U. L 345/64 of 31 December 2003.

[31] See arts 2 (1) lett d) and i), 14 (2) lett. b), 21 (3), lett. c).

[32] For example, information shall be provided on a continuing basis pursuant the Market Abuse Directive, art. 6; periodic financial statement are required by arts. 4-6 of the Transparency Directive.

[33] The Prospectus Directive, which only applies to instruments which are publicly offered or admitted to trading on a regulated market, for example, can be opted out in a number of situations. Enriques, Gatti (2007), pp. 12 ff. notice that; the concept of qualified investors is partly left to Member States (although a public consultation in currently in place at the EU level to revise this concept so as to include all the professional clients or eligible counterparties under MiFID: see http://ec.europa.eu/internal_market/consultations/2009/prospectus_en.htm); the directive risks shelter indirect offers to retail clients from the disclosure duties (when a direct offer without prospectus is made to qualified investors and the instruments are then resold to retail investors); the directive does not define liability rules, so that different implementations across Member States can lead to situations in which untruthful disclosure is never punished. See also Ferran, (building), p. 200.

making the experts to process (and work on the basis of) more information would allow for a better outcome in terms of investment allocation.

Consider the case involving lending, placement and portfolio management businesses. Portfolio management employees lawfully advise the purchase of these securities if the publicly available information shows that they have a risk-return ratio consistent with the investors' profile; and they have strong incentives in doing so, since the public information on which they can act shows that the same firm is also sponsoring the placement. If the lending arm could timely share the information showing that such ratio is not updated, the client could avoid what suddenly becomes an unsuitable investment. On the contrary, on the basis of the same public information, the securities could be offered to less risk-avers investors, for which the investment would in reality show being suitable despite appearances created by the available information.

Indeed, the concept of good or junk issue should be read from the investor's viewpoint: good investments might also mean highly risky ones, depending upon the financial capability and the risk profile of each investor. Some investors might therefore be willing to invest in the leveraged businesses if this bring about a probability of higher returns, despite the probability of higher losses.

In the case above, from the point of view of investors, some optimal matching are avoided. From the point of view of firms, if the returns granted by less risk-averse clients are higher than those granted by risk-averse clients (or if the majority of clients of the firm is of the first type), the looses some profitable businesses[34].

To address these cases, one could think of creating Chinese walls *ad hoc*, or permanently but with the possibility of trespassing them depending upon the circumstances. Both possibilities are either concretely difficult to realise in a complex business organisation or risky, since it is hard to *ex ante* define all the circumstances which allow for wall-crossing, and calibrate the intensity of information exchange which is deemed to be lawful for each of them.

Intermediaries could decide to take up these costs. Nevertheless, this seems to be prohibited under MiFID: Art. 22 (3) (a) of the L1 Directive makes clear that the exchange of information shall be prevented where it *may* harm the interests of *one* or more clients. This harm shall not be considered as actual, but merely as potential harm. Not only the wording itself clarifies this, but also the fact that these barriers are to be set-up before the business is commenced and the services are provided hints to this[35].

So far, I have not mentioned another determining aspect of the regulation on Chinese walls, the prohibitions on market manipulation, in particular insider dealing.

Intermediaries can be considered insider pursuant art. 2 (1) lett. c) MAD since they access the information during the course of their employment; the additional information of specialised arms of the firm falls under the concept of inside information since: it is of a precise nature, it is undisclosed, refers to one issuer and its financial instruments, is likely to sensibly impact the price of those instruments if disclosed (art. 1 n. 1). The above described matching would substantiate the

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[34] Optimal matching with less sophisticated clients can become an interest of the firm also where it has assurance that a mismatch in not legally prosecuted (as it is with the setting up of Chinese walls): specialised and non-specialised media are nowadays eager of this type of information, and this could lead to a consistent reputational loss, which can also translate in a market's loss of confidence in the industry considered as a whole.

[35] In fact, the organisational requirements are regulated by MiFID under the Chapter headed "conditions and procedures for authorisation".

prohibition of directly operating on the instruments concerned (art. 2), where realised through the management of clients' instruments; it would substantiate the prohibited behaviour of art. 3 (recommending or inducing third persons to buy or sell instruments), where realised through the service of investment advice.

The aim of this reasoning is not that of entering the debate on whether insider dealing prohibition are efficient, from the point of view of the market and the investors, but to make some points of MiFID and its provisions on Chinese walls. In this respect, it can be noted that the provisions on Chinese walls make nothing more than rivet the prohibition of insider dealing and mirror the business practices adopted to avoid the threat of insider dealing cases.

But since it was proven that they do not prevent all outflow of information[36], with respect to the intermediary-client relationship, they risk constituting an easy (merely procedural) defence against allegation of misbehaviour toward investors, and take the attention away from the possible exploitation of conflicts which derives from public information[37].

Safe for what just said about their effectiveness, where there is no additional information which could usefully flow to the market, Chinese walls also fulfil the interest of investor protection.

For example, they can avoid the damage which arises to clients when the firm acts on its own portfolio on the knowledge of clients' orders since the department which deals on the firms' own account, and that which deals on the account of clients are separated[38].

Beside these problems, the interaction between Chinese walls and disclosure duties creates further concerns.

If information is obtained by different arms of the firm which are separated by Chinese walls, *legally* no information is considered at disposal of the arm which did not have it in the first place, and is *tamquam not esset*, irrespectively to whether it could be lawfully be used under MAD. It follows, that the department bears no responsibility if it *de facto* acts on the knowledge of such information, and does not share it, or ignores it.

Chinese walls risk being an easy defence for employees which do obtain information and act upon it, despite the setting up of walls[39]. For this not to be the case, courts and authorities are required to be able to 'read though' complex organisational features, and elaborate common approved standards.

This does not appear to be the case, even by analysing the court decisions issued in only one jurisdiction, so that the implementation and enforcement of walls throughout Europe is likely to determine different levels of protection and un-level the playing field.

Let us take the English court decisions on fiduciary standards in principal-agent set-ups[40] where the matter of Chinese walls was called upon. After *Young and others v Robson Rhodes (a firm) and another*[41], *Prince Jefri Bolkiah v KPMG (a firm)*[42] and *Marks and Spencer v Freshfields Bruckhaus*

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[36] Enriques (2005), p. 12, Seyhun (2007), Lehar, Randl (2003).

[37] Enriques (2005), p. 12.

[38] This is nevertheless mainly relevant for professional clients, whose orders are worth it front-running.

[39] Lehar, Randl (2003), provide statistical evidence of the fact that information does flow between departments despite the existence of walls.

[40] These decisions do not directly involve investment firms, but rather lawyers and accountants.

[41] [1999] 3 All ER 524.

[42] [1999] 2 A.C. 222.

*Deringer*[43] rulings, intermediaries are expected to proscribe all professional contacts among employees; it is not sufficient for them to use different code names for different businesses or show that they engaged different people and servers or show that the work is done in different buildings. Rotating membership to departments is also likely to become an unlawful practice.

To use Katz's words, these rulings are "demonstrative of the courts' appetite to override firms' internal arrangements and impose strict fiduciary standards". But even among English judges some uncertainties remain: as to whether the wall can also be constituted *ad hoc* or should makes part of the existing business structure[44]; as to whether the firm should prove that it has enacted measures effective for the purpose of ensuring that "no disclosure will occur", or simply provide "convincing evidence that all reasonable measures have been taken"[45].

The effective application depends on the attentiveness of the judiciary body, as well as on the other rules (especially fiduciary standards) in place; it is not likely to be high enough in some jurisdiction, and for sure it will not be the same across countries.

Organisational rules do not go so far as to require removal of all the possible conflicts. Art. 18 (2) of the L1 Directive makes clear that where organisational arrangements are not enough to ensure, with reasonable confidence, that the risk of damage to clients' interests will be prevented, intermediaries should disclose the conflicts.

MiFID has reversed the relationship between organisation and disclosure, putting the former in the foreground at the expenses of the latter[46]. The circumstances under which the duty to disclose arises is at least problematic. As *Enriques* notices, firms are given a leeway in deciding whether or not their organisational arrangement are sufficient to prevent the risk of conflicts of interest' exploitation[47]. In the positive, no duty to disclose is triggered, but only the general and undetermined duty to treat the client 'honestly and fairly': "a bona fide judgment that those arrangements can prevent such risk … will imply no violation of the disclosure requirement, even if it turns out ex post that client's interests actually have been damaged"[48].

Pursuant as slightly different view (*Lener*), since firms always face the threat that their organisation is *ex post* judged as non sufficient, they shield the risk of controversies by informing the client in all cases of conflicts[49]. If this is true, the higher reliance on information is likely to exacerbate the problem of clients being overloaded by information which loses its significance[50].

I will now turn to the second regulatory pillar against conflicts' exploitation: *ex ante* disclosure.

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[43] [2004] EWHC 1337.

[44] See *Prince Jefri Bolkiah v KPMG (a firm)*, [1999] 1 All ER 517 at 530, with the opposite positions expressed by Laddie J and Lord Millett, respectively.

[45] Respectively: Lord Millett in *Prince Jefri Bolkiah v KPMG (a firm)*, 238 and Sopinka J, in *MacDonald Estate v Martin* (1990) 77 DLR (4th) 249, at 269.

[46] Recital 27 of the L2 Directive: "the disclosure of conflicts of interest by an investment firm should not exempt it from the obligation to maintain and operate … effective organisational and administrative arrangements … . An over-reliance on disclosure without adequate consideration as to how conflicts may appropriately be managed is not permitted".

[47] Art. 18 (2) of the L1 Directive.

[48] Enriques (2005), p. 6.

[49] Lener (2007).

[50] On this point more *infra* III.2.

### III.2. *Ex Ante* Disclosure.

Disclosure is probably the least intrusive way of regulating, which substantiates a light-touch approach[51]; a part the cases where proprietary information or competitive advantage could be put at stake, disclosure is therefore greatly hailed[52]. Imposing information disclosure is the lightest of all paternalistic measures – for promoting proper allocation of resources since it is little burdensome on intermediaries and puts investors' aware consent in the foreground.

Its correlation to a prominent feature of the principal-agent set-up, namely information asymmetry is indubitable. Information duties are therefore considered a fundamental tool against conflicts' exploitation[53]. The very reason why exploitation takes place lays with the principal-agent relationship and the information asymmetry between players. Hence, they appear to be the instrument better suited for addressing the market failures inherent to this relationship. Without disclosure duties the most informed player, the agent, would have the incentive not to share information with the least informed one, his principal, since only the asymmetry makes it possible and worth it to exploit the conflicts to the detriment of the latter[54]

It has always been considered the pinpoint of securities regulation[55], and the heart of the conduct of business rules for the provision of investment and ancillary services.

In a recent survey (world-wide and, for Europe, pre-MiFID), the Basel Committee on Banking Supervision has shown that, although disclosure obligations differ worldwide, the 'overall amount' of information reaching investors is similar: jurisdictions with less stringent general information duties feature stricter product-specific disclosure duties[56].

It is often argued that information is a measure which fosters investors' self-help and thereby enhances market discipline[57]. The usefulness of information is commonly argued irrespectively to whether one assumes that the market players are rational or biased investors.

When it makes appeal to rational investors, it is a tool for them to "discount the value of agent's performance"[58], pay less and thereby push out of the market the disloyal firms. For this to

[51] "Potential costs are limited, while benefits substantial": Zingales, (2004), p. 3.

[52] See *supra* n this Chapter.

[53] Hertig, Kraakman, Rock (2004); Levine, Loayza, Beck (2000). Langevoort (1999).

[54] Walter (2003), p. 12; Mishkin (2003), p. 222.

[55] The link between mandatory disclosure and enhanced allocative efficiency in the securities market is spelled out by Coffee (1984), p. 751, and Easterbrook, Fischel (1984), p. 67.

[56] Basel Committee on Banking Supervision (2008), pp. 15 and 37. This survey nevertheless shows that among all the information clients receive, that on conflicts (and inducements) is the least often provided. The Committee admits that the data do not show univocally whether all institutions provide such information only for part of the products they sell, or only part of the institutions provide information for the whole of their products. The data also has to be discounted by the fact that life insurances' practices – which fall outside the scope of the current work – are included in the total of the activities surveyed and feature very low rate of information about conflicts, thereby lowering the overall amount of information circulated. Data broken down by institutions still show that only 36% of banks and 30% of investment firms provide information about the conflicts requesting at least an acknowledgment of receipt.

[57] But one should not neglect that the full benefits of this can only be grasped under an optimal case-scenario, with an highly competitive market and low switching costs (or, better, switching benefits more than proportional to the switching costs), so that when investors are unhappy with the behaviour of the intermediary they normally deal with, they can resort to a different one.

[58] Kruithof (2005), p. 45, as also assumed Hopt (2004), p. 71.

happen, the disclosure must be informative. If not, a rational investor simply ignores it, and there having been disclosure does not impact on allocation efficiency, and only adds to the costs borne by the firm. When it is directed to biased investors, it should be such as to bridge information asymmetries but also, and more importantly, as to over-come (or at least not worsen) their biases. For example, it can be reassuring as to the worthiness of entry on the market, where investors are affected by omission/commission biases.

As behavioural finance has empirically shown "investor decision-making is systematically psychologically-driven and unrelated to fundamental information about asset values"[59]: full information is of smaller use than it could seem at first sight.

Moreover, there is empirical evidence that the provision of information can exacerbate the existent bounded rationality: when the less informed party of a transaction believes that she can count on the provision of information, cognitive biases affect her decision in a way that maximises the outcome for the other party. This point is made by *Cain*, *Loewenstein* and *Moore*[60], who show that, after having informed about the existence of a conflict of interest, the advisor feels 'morally licensed' and tends to have the interest of the client less into mind.

### *III.2.1. Information about conflicts of interest.*

Where organisational measures prove inadequate to protect clients' interest, firms have to disclose to the investors "the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf" (art. 18 (2) of the L1 Directive).

Pursuant art. 22 (4) of the L2 Directive, such information shall be provided in a durable medium and, apparently, the use of standardised formats is allowed. Art. 19 (3) MiFID explicitly mentions this possibility for the provision of information in general, and the articles specifically devoted to conflicts of interest, are not a sufficient ground to hold that in this case it should be otherwise.

"Before undertaking business on the clients' behalf" means imposing a different timing for the disclosure of this information than what would be otherwise applicable. The other rule setting the time for information disclosure, art. 29 of the L2 Directive, requires firms to provide the information (of art. 30) *in good time, before a retail client or potential retail client is bound by any agreement or before the provision of those services, whichever is the earlier*. The information about the existence of conflicts, instead, should be provided at the first contact, irrespectively to any subsequent activity undertaken with the client or on her behalf. Contrariwise, after such activities – but before the client is bound by any agreement or the service is provided – the client is entitled to receive the description of the firm's conflicts of interest policy (art. 30 (1) lett. h) and i)) and further details of that policy are to be provided upon request.

The crucial question to answer is whether the information is meaningful for its recipient. The European regulation seems wary as to the level of details the information should contain.

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[59] Moloney (2006), p. 407. Also: Stout (2003), p. 639, Lagevoort (2002), p. 135; Gilson and Kraakmann (2003), pp. 717 ff. There is a number of studies pertaining to different areas of finance demonstrating that investors are affected by strategic ignorance and bounded rationality: Boni, Womack (2002 and 2003), Malmendier, Shanthikumar (2006), De Franco, Lu, Vasvari (2006). See the discussion of Chapter I.4.2..

[60] Cain, Loewenstein and Moore (2005).

In this respect, it is not clear what one should understand under MiFID's words referring to "*general* nature *and/or source* of conflicts". It is more than what already contained in the summarised description of its conflicts of interest policy ex art. 30 (1) lett. h) of the L 2 Directive, but probably not much more given the blurry wording.

This, coupled with the circumstance that the information should be provided before the client is even made aware of the types of services she could receive, or instruments she could be provided with, raises doubts as to the possibility to make the clients truly aware of the conflicts she will face[61].

The level of detail of this information is not enhanced by other provisions. Those on the disclosure of the risks inherent to a transaction (conflicts' exploitation is indeed one of these risks) only require to generally describe the risk and warn on other circumstances (the leverage and the risk of losing the entire investment, the volatility of the instrument etc.) which do not include conflicts of interest (art. 31 of the L2 Directive).

True is that art. 22 (4) requires to include in the information sufficient detail to enable the client to take an informed decision, but the other provisions related to this obligation risk shielding the firms from all responsibility in case they transmit fairly general information. Significantly, no provision explains what should happen after the client is provided information by this means, whether she should give a receipt of acknowledgment or confirm her intention to act. Also, scholars in majority argue that a one-and-for-all disclosure is sufficient for all services, in light of the directive's wording[62]. These regulatory voids can be filled in with the application of the general clause of fairness; they are nevertheless indicative of the little reliance of the regulator on the fact that clients act on the basis of this information.

Is the information which merely conveys awareness as to the endemic existence of conflicts of interest informative for the different types of clients above?

One could argue for the positive in case of rational agents: it highlights that they are dealing with an intermediary which faces certain types of incentives to pursuing other persons' interests. Nevertheless, it does not say whether that firm will actually exploit the conflict. Facing such uncertainty, investors might (rationally) choose to reduce their willingness to pay and are protected from the threat of over-paying for the service received.

Read under these lenses, the aim of this provision is that of avoiding that *that* firm is paid more than its standing would justify[63]. Thereby, it calls for a market mechanism to push avoidance of conflicts[64]. But as seen above, this mechanism requires a competitive market and low switching costs[65], Moreover, if the client indiscriminately discount the services provided by any firm, those

[61] On the contrary, Fusetti, Recine (2007), p. 171, point out that the provision of information in standardised formats does not contradict the possibility that the information is understandable by the client to whom it is directed.

[62] Mülbert (2006), pp. 303 ff.

[63] In fact, other provisions avoid that the specific instrument is over-paid, namely the disclosure duties as to the features of the investment: *infra* III.2.2. See also Kruithof (2005), p. 40.

[64] I have not neglected the fact that the concept of meaningfulness has little bite, since perfect meaningfulness could only be predicted of communications which also disclose whether or not the conflicts declared will be exploited. This being unfeasible, information is limitedly useful for rational investors which are able distinguish loyal from disloyal firms, if these investors act in a competitive market with low switching costs: an optimal case-scenario of which too many features do not appear in the modern financial markets.

[65] *Supra* I.4.3.

which bear the additional costs connected with an exact compliance will be pushed out of the market: the problem of adverse selection is exacerbated This hampers competition which, as already stated, is a market safeguard of the intermediaries' proper behaviour and, in the last place, market efficiency[66].

This information could exacerbate clients' biases, since they simply convey the idea of a firm bearing a number of conflictual situations. What information would instead be needed?

Imagine the case of the lending relationship: intermediary lends to an issuer which is going through hard financial times. Where the intermediary is aware of the hardship which could impede the reimbursement of the loan, it is clearly interested in advising the investor to purchase some of the issuer's stock, so that new funds flow to the business and help it out of distress, although the client might be willing to invest in a safer business. Exclusively mentioning there being a business relationship with the issuer is not sufficient to make the client aware of the real terms of the situation; on the contrary, it could be considered as a sign of reliance, from the part of the intermediary, on the soundness of its business. Making the investor truly aware of the conflicts would mean informing her about the lending relationship and *also* the deteriorating financial conditions of the issuer. The same holds for the group example: knowing that a group company is the issuer can push the client to assume a more sophisticated knowledge of the instruments, and therefore to more heavily rely on the firm's advice.

This proposal can not be pursued because of Directive 2003/6/EC (Market Abuse Directive, hereinafter: MAD)[67]. Art. 3 prohibits insiders from disclosing inside information to any person, and from recommending or inducing other persons, on the basis of insider information, to acquire or dispose of financial instruments to which that information relates. Art. 1 (1) subparas. 1 and 3, and art. 2 (1) lett. c) render the intermediary an insider with respect to the information on the financial situation of the firms, which in its turn, is inside information.

The exception of art. 3 cannot be usefully applied: it allows the use of inside information "in the normal course of the exercise of … employment, profession or duties". Its scope is nevertheless only limited to market makers and "persons authorised to execute orders on behalf on third parties with inside information"[68].

The result risk being that of clients receiving papers with little informative content, and being provided with them in innumerable cases: the described rules create all incentive for intermediaries to 'disclose' as much as possible in order to avoid risks of non-compliance.

Nevertheless, it is easy to find cases of conflicts of interest where information about their existence does not add anything to what clients already expect.

Churning is a behaviour which substantiates the exploitation of a conflict of interest between the firm and the client: the former undertakes on behalf of the latter a number of transactions which is disproportionate to her financial capability, to her level of risk aversion or, simply, to the result one can reasonably expect from them, and does so to charge more commissions. If the client knows from the outset that the remuneration is linked to the amount of

[66] See Kruithof (2005), p. 40. *Supra*, I.2.

[67] Directive of 28 January 2003, published in O.J.E.U. L 96/16 of 12 April 2003.

[68] I.e. it would only apply if the client, not the firm itself, has inside information, and the firm is just executing her orders.

activities undertaken on his behalf[69], the client needs no additional information as to the firm's incentives. The additional information she would need to control exploitation relates to the market, to the financial instruments, to what the adequate level of investments would be, given her financial situation. In other words, she needs information other than that on the existence of incentives to over-trading[70], while that on conflicts of interest appears to be useless.

Consider the case of front running: the transaction executed on the client's behalf might well be, *a priori*, the best suited for her. Only, the firm's *ex post* intervention lowers the expected return of the investment. The piece of information which the client *ex ante* needs relates to whether or not the firm will exploit the conflict, which is unreasonable to expect. Otherwise, there is no conflicts of interest on which the client can be made aware.

Consider the preferential treatment firms can accord to some clients, thereby exploiting the interests of others. The general nature/source of the conflict lies with the multifunctionality, or the mere fact that more clients are provided the same service, which all clients can expect to be the case. What the clients do not know is whether these circumstances are going to bias the provision of services: whether the other client is treated 'preferentially', whether the instruments issued by group companies are adequate to her profile, whether the loan risks not being recovered. One could argue that more information can be provided under the duty of honesty. This general clause can indeed supplement, but then it also should be applied to control the timing of disclosure and its frequency (*ex ante* once-and-for-all information likely not passing the test).

With its implementation in Member States, the provision risks being an easy way for clients to opportunistically use the failure from the part of the firm to provide information. They could argument on this failure to void an otherwise effective contract as soon as the market conditions turn against them. The result would be that firms end up bearing a risk which investors should have consciously taken, a risk that no regulation – even the more protective – could avert from investors.

This provision seems to be necessary for common law States, where regulatory duties has always interacted with fiduciary standards. To avoid that the strict application of these standards impedes all activities from the part of intermediaries, since they prohibit an agent to have any conflict of interest (irrespectively to whether it manages them or not), financial services' regulation has always embedded a mechanism of disclosure of the interests which, coupled with the client's consent allows intermediaries to act for their clients.

### III.2.2. Other *ex ante* information.

[69] Se *infra* IV.1.2. for a discussion about the remuneration structure and the fact that it is becoming less predictable.

[70] The information of art. 19 of the L1 Directive, which levels the information asymmetry inherent to the principal-agent relationship: *infra*, III.2.2.

The idea of clients' awareness and informed decision justifies other provisions. Clients have to be provided with other extensive *ex ante* information, in particular on the features of the investments[71].

Thereby, MiFID aims at avoiding the exploitations which translate in clients being offered a riskier investment than they would need or expect. This exploitation does not necessary amounts to a direct loss to clients, more is linked to the concept of potential losses.

This is paternalistic in that it obliges firms to undertake costs and bridge information asymmetries which they would not otherwise bridge, but is paternalism in its lightest-touch form and gives consideration to the fact that the players on the market have different degrees of professionalism: the least sophisticated ones are given the tools to avoid errors, while the good choices of the sophisticated ones are not prevented.

There only is one setting under which information flows can be deemed useless: where investors are fully irrational and in no way possess information which could be usefully circulated in the market, while intermediaries are both able and willing to make the right choices for their principals. In all other cases – which are the rule and not the exception – information is a crucial tool.

Given the findings above on there being mixed evidence on clients' irrationality, on professional investors' biases and on the need for mechanisms which enhance market discipline, a no-information system would trigger more costs than benefits[72].

Rules on *ex ante* information should ensure that, as to its timing, the circulation of information does not take place at a time where it cannot impact on the clients' decision-making process anymore. On the other side, it shall not unduly hamper the smooth performance of investment activities, since their efficiency can be negatively impacted by delays in the execution. Its mandatory content has to be meaningfully as compared to its recipients' awareness and biases. A too high level burdens firms more than its expected benefits would justify; a too low level deprives the provision of information of its client-protective purpose.

MiFID's rules on *ex ante* information are extremely detailed. Those on timing allow clients to receive information in due time. As a rule, information about the terms and (the other circumstance of the agreement pursuant art. 30) shall be provided "in good time before a retail client or potential retail client is bound by any agreement ... or before the provision of … services, whichever is the earlier" (art. 29 of the L2 Directive).

Also, before the provision of the services, the information of arts 30 to 33 of the L2 Directive shall be provided: about the firm and its services and about the financial instruments and their risk (together with the information about costs and associated charges above).

Exceptionally, the information about the terms and other circumstance of the agreement, can be disclosed after the client is bound by the agreement, and all other information can be disclosed after starting to provide the service. The exceptions related to the unsolicited use of means of distance communication which does not allow to provide information before.

This strikes a balance between the need for informed consent, and the promotion of new and flexible means of communications which enhance the speed of transactions.

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71 Moloney (2006), pp. 394 and 400, talks about "regulatory strategy based on supporting autonomy and choice".

72 La Blanc, Rachlinski, (2005).

The regulation also allows for the provision of information in standardised form (art. 19 (3) of the L1 Directive), which should serve both intermediaries' and clients' interest: by introducing disclosure standards the regulation abates the costs for firms, while allowing for a wider comparability for the benefit of investors. Lacking regulatory standards "each firm will naturally choose the format that is most favourable to its data, impairing investors' ability to make comparisons across firms"[73]. Nevertheless, to be meaningful, the information shall be communicated – despite standardisation – in a form such that the specific cognitive biases of its recipients do not hamper its understanding.

Firms shall communicate to their clients information on: their categorisation, the investment firm itself and the services it provides, the financial instruments and the risks associated to them, the proposed investment strategies and the risks associated to particular strategies, the execution venues and their costs, the measures enacted for the safeguard of clients' instruments and funds, the costs and associated charges.

Where relevant, the description of risks shall include an explanation of leverage, its effect and the risk of losing the entire investment, the volatility of the price and any limitations on the available market for such instruments, the possibility that the investor assumes financial commitments additional to the costs of the instruments, margin requirements and similar obligations (arts 19 of the L1 Directive and 28, 30-33 of the L2 Directive).

Disclosure should be fair, clear and not misleading, this meaning that it shall: be accurate, not emphasise potential benefits or disguise relevant risks or other important items; be sufficient and presented in a way which is likely to be understood by the *average member of the group* to whom it is directed (arts. 19 (2) of the L1 Directive and 27 of the L2 Directive)[74].

Standardisation does not hamper this possibility, since firms can elaborate standard forms for each 'group of clients'. Nevertheless, it leaves in the background the problem of comprehension from the part of each individual investor.

Art. 19 (3) of the L1 Directive states that disclosure shall be such that clients are reasonably able to understand the nature and risk of the investment service and of the specific type of financial instruments, to take an investment decision on an informed basis[75].

What is the relationship between art. 19 (2) and 19 (3)? One could also argue that the former only relates to the form of the information, not its content, since it reads "*presented* in a way" which can be understood by the average member of each group[76]. Nevertheless, if the standardisation only related to the form, and not to the content, some of its important economies would be lost[77].

[73] Zingales (2004), p. 20.

[74] More detailed rules are provided in the same article for the cases in which the information makes comparisons, indicates past and future performances. There is a mismatch between the L1 and L2 Directives: whereas the former refers to information duties for the benefit of all clients, the latter specifies the content of the L1 provisions only with reference to retail clients.

[75] Art. 3 of the L2 Directive also addresses the threat that when allowed to provide information on a durable medium, intermediaries use mediums other than paper and this lowers the possibility of the client to access or understand it.

[76] Under this interpretation, the standard form shall include clear and strong warnings that past performances represent no guarantee, if its recipients tend to feature a past-performance bias, i.e. tend to lean on past results when determining the future expected ones.

[77] Mülbert (2006), pp. 303 ff.

One should turn to other provisions to fully understand the level of detail which shall be included in the communication to clients. All in all, the provisions seem contradictory on the matter of disclosure's specificity.

Art. 3 of the L2 Directive apparently allows firms to provide the information about financial instruments and their risk (that of art. 31) in a way which is not tailored on the client, through the means of a website. True is that this possibility is allowed only with the client's consent, so that this is not a sign in itself that firms do not have to pursue the abovementioned level of specific awareness[78].

The information shall be "general" pursuant art. 31 of the L2 Directive but shall also explain the nature and the risks of the specific type of instrument, in sufficient detail to enable the client to take and investment decision on an informed basis. The second part of the obligation might on the contrary imply the need for instrument-by-instrument information.

Upon closer sight, one could nevertheless argue that reference to risks of the "specific type of instruments" does not equal making reference to the risks of the specific instrument.

If one could find in MiFID some provisions requiring firms to issue information on an investment-by-investment or service-by-service basis, one could have stronger reassurance that the communication to the client truly has to take into consideration the peculiarities of each case, and contribute to the creation of clients' informed consent on each of them.

*Mülbert* argues that, under MiFID's wording, information shall not be provided any time the firm offers a new service or an existing service in relation to a different type of financial instrument: otherwise, he argues, "investment firms would hardly benefit from the option to provide information in a standardized format"[79]. On this respect, it is worth it noticing that the duty to provide information about the strategies is confined to the L1 provision of art. 19 (3) and has not further specification in the level-2 measures[80].

Leaving such an important aspect of clients' protection through non paternalistic approaches blurry is for sure indicative of the mental approach of the European regulator on the matter of the means trough which financial markets can become a safe and fair environment for investors. As I will point out *infra*, while the regulatory lacunas could be addressed though the general clauses of honesty, fairness, professionalism of art. 19 (1) of the L1 Directive, CESR's technical advices might well have restrained this possibility on the matter of information.

**Conclusions.**

In this chapter, I have analysed the two main regulatory ideas and they tools which enact them. The first idea is that potential conflicts of interest should be managed internally to the firm.

[78] It is nevertheless indicative that even retail clients can opt out from a highly protective but not paternalistic measure which apparently does not weigh too much on the firms' cost of compliance.

[79] Mülbert (2006), p. 306.

[80] Mülbert (2006), pp. 306-307 expresses heavy concerns on the fact that instrument-specific information shall not be taken into consideration and mentions the case of rating of securities as an example. Upgrades or downgrades in the ratings are an extremely telling information on which it could be useful – and in the interest of the clients – to trade.

For this purpose, the directive identifies focuses on a number of organisational measures which firms should adopt, as far as economically feasible.

I have stressed that some measures of this type are useful to protect clients' interest. This is the case for the those which ensure separate supervision and remuneration of employees serving in different departments.

Chinese walls are by far the most renown organisational tools, which MiFID renders almost mandatory. I posit that they serve little purpose – except for one case where mainly professional investors are concerned – when clients' interests are at stake. Their true nature rests with the protection of the market against market abuses, and they reinforce the prohibitions of insider dealing. Where it not for these prohibitions, some information outflows (which could be obtained raising walls on a case-by-case basis) could benefit individual investors(and be a firms' business interest).

As to the under-protection they can result in for clients, I have mentioned that they risk to exempt from responsibility intermediaries even if the information *de facto* flows and employees unfaithfully act on it or ignore it.

The second regulatory idea I have described is that of clients' informed consent. It is implemented through the tool of *ex ante* disclosure.

I posit that information about the existence of conflicts – as it is depicted by MiFID read in conjunction with MAD – can be considered, at most, addressed to rational investors, which are thereby required to exercise market discipline through a discounting mechanism. For other investors, it is not meaningful and risk exacerbating cognitive biases. Upon closer sight, the duty to provide clients with this information was needed for common law jurisdiction where the fiduciary duties would otherwise impede intermediaries to perform their services.

Coming to the other information duties (regarding the investments, the strategies etc.) I have highlighted, as a major source of concern, the fact that their content is fairly general. The web of provisions on this matter is intricate, but most of the indices point to that. Thereby, the very reason why information is provided – that of putting clients' decision in the foreground, risks being frustrated.

# Chapter IV

## Beyond MiFID's Basic Regulatory Ideas. The Other Conduct of Business Rules.

Beyond the basic regulatory ideas, MiFID contains and extensive conduct of business regulation which aims at addressing the risk that intermediaries don't serve the clients' best interest because of the exploitation of conflicts of interest due to both agency and common agency set-ups.

These rules can be grouped around three groups: those addressing the possible exploitation of clients with the choice of the investment; those addressing the exploitation of clients whose monies is not put at their use; those addressing the exploitations possible at the point of execution. By so doing, the European regulator is aware that clients do not know what they need, cannot evaluate what they receive and what they can expect from their agent.

At the point of choice, the clients' interest is neglected if they receive unsuitable investments, receive suitable investments but their monies are not all put to their benefit[1].

At the point of execution, the clients' interest is not fulfilled because of the conditions of the execution: its timing, means and price can be chosen to favour the firm itself or another clients.

All in all, a considerable number of obligations burdens intermediaries; MiFID seeks to graduate the compliance costs depending upon the threat that each service entails. On this basis, those services which ensure to the intermediaries an higher degree of discretion are made object of a more intense regulation.

After having described these obligations and shown how they apply to different cases, the aim of this chapter is evaluating the extent to which they succeed in protecting clients and the extent to which, on the contrary, they impose costs which are not justifiable in light of the possible benefits.

The way I group the conduct of business rules is not based on the explicit wording of MiFID, but is an attempt to find the *fil rouge* through an intricate and complex web of obligations. If one agrees that the threats identified are (not only but) the main problems arising in this principal/agent relationship, this is a way to directly analyse the solutions as against the problems they address. Since some rules inevitably serve more purposes, I recall them several times, but I endeavour to emphasise different aspects each time.

I focus on agency exploitations, as different from the common-agency exploitation, but I do not address the services separately. The reason is that all rules apply to all services. This does not contradicts what said above about the graduation of compliance costs. Indeed, a notable exception to the general application of the conduct of business rules lies with the suitability and

[1] The risk that clients, despite being offered suitable investments which they do not 'overpay', they nevertheless receive something which is riskier than what they would have thought is addressed by the ex ante information duties described in Chapter III above.

appropriateness tests. The former applies to the high added value services of portfolio management and investment advice; the latter to all other services, safe for execution-only ones on non complex instruments. They address the threat that clients' interest is neglected at the point of choice of the instruments and are therefore the first rules I evaluate.

## IV.1. Conflicts of interest exploitation at the point of choice.

### *IV.1.1. Exploitation of the client in the choice of the investment.*

#### *IV.1.1.1. Suitability Rule.*

Portfolio management and the provision of investment advice are the services which feature the highest risk of exploitation. The reason for this is that, in the former, the agent has intense discretionary powers which allow it to operate on the principal's portfolio at its choice, without obtaining a case-by-case authorisation of the transactions undertaken.

This is an unavoidable feature of this service and a value to the investors. Insofar as discretion is not used to further own interests, they benefit from the evaluations of a professional agent which, on the basis of a whole picture of the clients' portfolio acts when and how it deems it to be necessary.

The risks that clients' portfolios are managed so as to further the intermediary's interest should not be underestimated. The agent who can choose the financial instruments to include in the portfolio might for example dump in it all the investments it holds on own account any time they turn out to be worth less than expected. Furthermore, a discretionary management of clients' portfolios is the best means to ensure that an issuance sponsored by the intermediary for a firm-client is placed to a sufficient extent.

The provision of investment advice features a similar level of discretion but clients risk being exploited on different grounds. The intermediary can suggest the choice of the same instruments as above, but then the order comes from the part of the clients. The very reason why clients resort to this type of service is that the firm stands out to them has having superior knowledge and being best on the footing to know what they need. It thereby gains a level of trust which clients are highly likely to rely on and can curb the clients' investments to the intermediary's sole advantage.

MiFID relies on the suitability rule which applies to portfolio management and investment advice[2] at the point of choice of the financial instruments on which to act, and should protect the investors from losses linked to the fact that the investment does not match their profile.

[2] Basel Committee on Banking Supervision (2008), p. 2, in its world-wide survey on suitability, finds out that in most countries the suitability duty "only arises when a firm makes a recommendation or provides advice … to a client to purchase a product. Where no recommendation is made, some jurisdictions require that disclosure be made or that a client be 'warned'".

When describing the services, I have often pointed out the possibility that an unsuitable investment can be provided to the client when the firm is giving preference to its interests: when it places with preference instruments issued by other companies of the group to which it belongs, or issued by an issuer with which it has an outstanding lending relationship or other business activities.

Under the suitability rule, intermediaries shall verify that the type of investment and the financial instruments concerned match the client's profile. They should meet that client's investment objectives, their risk should be readily understandable and consistent with the investor's financial capability (arts. 19 (4) of the L1 Directive and 35 of the L2 Directive, recital 58 of the L2 Directive)[3].

The suitability should be assessed by the firm before advising the client to undertake the investment, or make portfolio management choices. Recital 57 of the L2 Directive clarifies that suitability has to be assessed with a global approach: "a series of transactions which are each suitable when viewed in isolation may be unsuitable if … [their frequency] is not in the best interest of the client. In the case of portfolio management, a transaction might also be unsuitable if it would result in an unsuitable portfolio".

For this purpose, intermediaries have to gather information on the client (the 'know your customer rule'), on the one hand, and on the financial instruments and the type of investments (the 'know the security rule'), on the other hand.

Art. 19 of the L1 Directive, as specified by arts 35 and 37 of the L2 Directive, itemise the information to be collected from the client: her knowledge and experience in the investment field relevant to the specific type of product or service; her financial situation and investment objectives. 'Knowledge as to the financial situation' means awareness as to the source and extent of the client's income, assets, investments, real propriety and regular financial commitments. Clients' investment objectives are appreciated enquiring upon the timeframe for which they wish to hold the investment, their aversion to risk, their purpose for the investment. Clients' knowledge and experience can be inferred from: the type of services and instruments which they are familiar with, the nature, volume and frequency of transactions previously undertaken; their level of education and their profession.

Once obtained such information, firms should be able to produce a 'table of correspondence' between the overall profile of the client and the investments which could suit it for risk and complexity: nothing in the regulation prohibits firms from making the process more efficient by grouping the clients in classes, and by identifying a leading strategy for each class.

This rule also extensively draws from previous experiences: a world-wide overview of firms' practices conducted by the Basel Committee before MiFID shows that more than 80 percent of the sample already gathered information on the family situation, the net worth and income of the customers, the type of assets held, the level of knowledge and time horizon, in addition to the information about the age, the investment experience, the risk appetite, and the investments' purposes[4].

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[3] Pacces (2000), pp. 488-489.

[4] Basel Committee (2008). The Committee presents aggregated data, so that is it difficult to asses the European pre-MiFID business practices: it nevertheless gives a hint of what was the maximum level of information gathering which has been put into practice for the purpose of assessing suitability.

Other information, which firms are now not required to obtain under MiFID already seemed underrepresented: the tax status and the diversity of portfolio, the need for guarantees, the existence of a gearing strategy, the need for a loan to finance the transactions[5]. Apparently, the European regulation has sought to align to the average of all market practices, probably in order to not excessively increase the costs of compliance with the new rules.

Nevertheless, gathering additional information of this type would only have added trivial extra costs to the overall process. The choice was more clearly based on the threat that adding too many variables to the assessment of clients' needs would make it very difficult for firms to find investments which are truly able to pass the suitability test.

In theory, such test might well block the operations of intermediaries. MiFID tries to avoid this situation, and adds flexibility to the rule as described so far. Pursuant art. 35 of the L2 Directive, firms shall obtain such information *as it is necessary* for them to understand the essential facts about the client and to have a *reasonable basis* for believing that the investment matches the clients' needs. This sufficiency test should allow to take into consideration the circumstances of each case[6].

Although MiFID does not require firms to regularly control and update the information[7], reasonability and good faith tests should be applied to establish when the intermediaries can lawfully rely on the representativeness of the information at their disposal.

If all necessary information is provided by the client, the firm is entitled to rely on the information obtained, unless it is aware or ought to be aware that it is manifestly out of date, inaccurate or incomplete (art. 37 (3) of the L2 Directive). Clearly, an investment firms shall not encourage clients not to provide information (art. 37 (2) of the L2 Directive).

There are two critical points of MiFID's regulation: first, what happens if the information is not provided? Second, what is the possibility of superseding the suitability test through the clients' explicit request? Third, can they mould the suitability

A rule which impedes operations when the information is not provided might well lessen beneficial transactions on formalistic grounds.

If the information is not gathered because of the client refusing it, arts 19 (4) of the L1 Directive and art. 35 (5) of the L2 Directive seem to imply that intermediaries cannot perform the services[8].

MiFID treats both advice and portfolio management in the same way. Thereby, it appears to neglect the benefits of the widest availability of professional advice and management for the

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[5] These items were included in the CESR's 2005 Technical advice (2005d), pp. 27-28, which has nevertheless not been taken up.

[6] CESR, (2005d), p. 25.

[7] In the US, for example, it has to updated every 36 months: Basel Committee on Banking Supervision (2008), p. 14.

[8] Art. 35 is not uncontroversial: it obliges the firm to refrain from providing 'recommendations'. It is legitimate to ask whether the provision of portfolio management remains possible. This ambiguity can be overcome analysing art. 19 (4): it also only uses the term 'recommendation', but from the outset of the paragraph ("when providing investment advice *or portfolio management*", emphasis added) it is clear that reference is made to both services.

clients, and of the possibility of having a professional point of view, irrespectively to the amount of information which they are willing to disclose[9].

To ensure this, the Commission could have taken up the 2005 CESR technical advices on the implementation of L2 measures[10]: it distinguished two cases: *if the firm does obtain all* the information requested, but still esteems that it cannot draw a complete picture of the client thereby, it can still provide the service envisaged to the extent that it appears to be suitable, or any other suitable service; *if the firm does not obtain any information*, it should verify whether the necessary information is otherwise available. In the negative, it has to proceed on a cautious basis, for example assuming no knowledge or no experience at all from the part of the client[11].

Under this framework, firms would be always given the possibility to refrain from the provision of the service[12] "if they have the feeling that an assumption cannot replace the information in a meaningful manner"[13]. But if the assumption is about the client having no experience, no authority can seemingly raise objections to firms who provide advice or portfolio management on instruments of the least complex type and featuring the lowest risk.

The second question above can be rephrased as follows. Can intermediaries perform investments other than those which they have identified if this is required by investors? A rule which impedes clients to take control of their transactions after the intermediary's judgment might well avoid that the least informed investors err in their choices; on the other side, it contextually deprives more informed clients of the possibility to act on the basis of their information, which is thereby spread to the market and could also result in better investments. Let alone the problem of insider dealing, investors could have more information at disposal than the employee if, as seen in the discussion of Chinese walls, some information does not (legally) flow between departments of the firm.

MiFID requires intermediaries to "recommend to the client or potential client the investment services and financial instruments that are suitable for him" (art. 19 (4) of the L1 Directive. In lack of further indications, nothing would impede that the clients request a service or an instrument other than that advised by the firm.

But for both services to which the suitability rule applies, there are indices that contradict this. For investment advice, the fact that – as highlighted above – the information about the instruments and the strategies to be provided to clients is generic, the investor is not put on the footing of taking decisions contrary to the firm's ones. For portfolio management – as we will see *infra*[14], the clients is explicitly left the choice to take decisions only on a limited range of investments.

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[9] CESR (2005b) distinguished the two, and stressed the importance of allowing firms to otherwise gather information, in particular for the provision of investment advice.

[10] CESR (2005b), pp. 23-24, and 2005-290b, pp. 25-26.

[11] CESR (2005b) appears to distinguish investment advice and portfolio management, and stresses this solution for the case of advice in particular.

[12] As shown by the Basel Committee on Banking Supervision (2008), p. 36, refrain from acting is a world-wide renown business strategy when intermediaries lack information: under this circumstance, 31 percent of surveyed banking institutions, 47 percent of insurance companies, 33 percent of investment firms and 58 percent of mutual funds does not proceed with the selling.

[13] CESR (2005b), p. 24.

[14] *Infra* V.2.

For both, and unlike what happens with the appropriateness test, MiIFID does not explicitly mention that the firm has to issue a warning as to the unsuitability of the investment. But if the client could choose on its own, this would necessary follow from the concept of the suitability test.

This approach coherent with the fact that unsophisticated investors have preferences of which they are not aware of, or which they cannot interpret: intermediaries intervene to bring the preferences, correctly estimated, to the market[15]. But as seen in Chapter III when discussion the information duties, this is not the type of clients assumed by the MiFID. As mentioned above, the *ex ante* disclosure is devised so as to address information able to exercise market discipline, once the information asymmetry is bridged.

This approach can also have some justification, if only one considers that intermediaries stand out as professionals acting for the clients' interests and investors are thereby more likely of being fooled, but is extremely costly, especially if one considers that MiFID– making a choice which is new to a number of European jurisdictions – applies the suitability test to professional clients as well.

For these clients (as mentioned in Annex II (1) of the L1 Directive) the test is rendered easier, since firms can assumed to have sufficient knowledge and experience[16], but still clients cannot otherwise instruct the firm. The simplification of the suitability test for professional clients is therefore constructed to accommodate for intermediaries' needs to abate compliance costs; not to minimise the errors of those who would err while not adding to the costs of those investors who would not err[17]. But if this interpretation is correct, the flow of information to the client is rendered purposeless, since the client can not act on it[18].

The suitability test reinforces the idea that the duty to disclose conflicts of interest, as it is devised, serve little purpose and can be opportunistically used. Such disclosure is purposeless if it is given with respect to investments which are not suitable: the firm is anyway prohibited from undertaking them. Despite disclosure, where the suitability rule applies, it is in the hand of the intermediary to choose the investment which fulfils the client's needs. If it does so, the clients' interests are protected by the suitability rule, and not by the information duties; if it does not do so, it is the breach of the suitability rule, and not that of the information duties, which gives rise to a detriment to the clients.

Hence, the only result of the information duty is to create uncertainty as to the means each national legal system will deploy to ensure its enforcement. In some jurisdictions, its breach is likely to give rise to the nullity of the contract, with the threat of opportunistic use mentioned above[19].

*IV.1.1.2. Appropriateness.*

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[15] Pacces (2000), p. 488.

[16] For all other clients which may be treated as professionals upon request (those of Annex II (2) of the L2 Directive), CESR requires to assess their knowledge and experience on a case-by-case basis.

[17] See above, Chapter I.5. the discussion of asymmetric paternalism.

[18] See *supra* the discussion about information overload. Following CESR (2005d), p. 55, Box 9(2): the information duty of art. 19 (3) does not apply to all services: this would solve the problem of information overload, but also reinforces the conclusion that clients are not allowed to take control of the investments.

[19] Chapter III.

MiFID's proportional approach translates into the fact that the suitability rule only applies to portfolio management and investment advice. Beyond these services, the rule is replaced by the so-called appropriateness test. Pursuant art. 19 (5) and (6) of the L1 Directive, it applies to all other services, safe for the execution and/or reception and transmission of clients orders (with or without ancillary services) when they are provided on an execution-only basis (art. 19 (6) of the L1 Directive), which is nevertheless conditional upon restrictive circumstances[20].

To comply with the appropriateness test firms shall in principle ask clients information regarding their knowledge and experience in the investment field relevant to the specific type of product or service offered. This does not exclude that in certain cases, "the investment firm may look at the wider knowledge and experience of the client"[21]. Art. 37 of the L2 Directive specifies that the information about the client should include the services, transaction and financial instruments with which she is familiar; her trading history and her level of education and her profession. As a difference to the suitability rule, the appropriateness test does not take into consideration the client's assets and incomes, or her objectives for that specific investment. It only aims at mirroring the main features of the previous activities she has undertaken on the market.

On this basis, the firm shall estimate whether the products and the services are appropriate, this meaning that the client is able to understand the risks they entail (art. 36 of the L2 Directive)[22]. In the negative, it should warn the client, eventually using standardised formats[23]. In no way MiFID explain what should happen after the warning has been issued, whether – and how – the client should reiterate its intention to invest.

If the information is provided, as with the case of suitability, the firm is entitled to rely on it pursuant art. 37 (3) of the L2 Directive (art. 37 (2)).

If the information is not provided, or the information provided is insufficient, the intermediary is relieved from responsibility and exclusively has to inform the client that it will not be able to make an appropriateness evaluation. Although firms shall not encourage clients not to provide information, MiFID does not provide for a mechanism which allows to control that they do not do so: the client for example, is not required to declare in a durable medium that she is willingly not providing information, and is aware of the loss of protection it triggers.

Also, CESR excluded that updating and ongoing control duties could be useful in compliance with the appropriateness obligations. Indeed, in this case "if the client is interested in a modification of his risk profile in order to be able to trade other types of financial instruments, engage in other types of transactions and/or order he will inform the investment firm accordingly"[24].

Some critiques can be put forward: first, on the type of test the firm has to undertake. Clients are protected not if firms make sure that their current investment mirrors the ones previously undertaken (as required under the rule), but if the current investment entails

[20] See also recital 58 of the L2 Directive.

[21] CESR (2005d), p. 31.

[22] CESR (2005d), p. 32, suggested to explicitly mention that firms are required to create a table of correspondence between the client's type and the investments, orders, instruments which adequate to such type. An explicit provision of this kind was nevertheless not included in the MiFID's final implementing measures.

[23] The content of the warning is clear on the sole basis of the level-1 provisions: thus, CESR (2005d), p. 31, suggests it should be as short and concise as possible.

[24] CESR (2005b), p. 25.

diversification while matching the clients' current aversion to risk and financial capability. Second, as to the fact that firms do not have to update the information, and can rely on clients requiring for it: since the rule introduces a duty of advice (albeit limited to some issues), it seems contradictory to imply that the client is autonomously aware of the circumstances which change her needs and need to be pointed out to the firm to be able to more extensively operate. Third, it could have been usefully explained what happens after the warning. For example it could have been openly stated that she can act after having confirmed in written her intention to do so, despite acknowledging the receipt of the warning. By so doing, the regulation would have better ensured that the warning is considered by the client.

### *IV.1.1.3. Inducements paid to the firm.*

The incentives to neglect the clients' interest which come from outside the firm are addressed by the conduct of business rules on inducements. Inducements are the fees, commission or non-monetary benefits received by the firm from a third party (a person other than the client), or paid to a third party by the firm[25].

The commissions paid to the firm by a product-provider lay at the heart of an aggressive marketing of one product as against others and influence the types of instruments on which firms act on can bias the intermediary's behaviour in the choice of the investment for the client[26]. They can determine both a product-specific and a provider-specific bias.

Nevertheless, some of these inducements are needed for business to take place. In Ch. VIII, I emphasise that the marketing of some products would not take place if intermediaries were not accorded benefits to this end. I stress it with reference of UCITS' units, since their marketing is the least remunerative part of the chain which starts with the design and management of the instrument to its commercialisation. But the same can easily be said to happen for any new product for which requires intermediaries to undertake understanding and managing costs.

In addition to this, some inducements are necessary for the provision of services: custody costs, settlement and exchange fees, regulatory levies or legal fees.

Lastly, providers might well need to remunerate the intermediaries for the services they are provided, such as after-purchase advisory or management ones. Post-sale services can also be properly performed when the clients themselves pay for them: this would also have the benefit of making the client choose as to whether she wants these services, and the intensity thereof. Nevertheless, payments from the part of the producer respond to a legitimate business interest of its: that of standing out to the market as an offeror of service with high added value.

Against this backdrop, let us now consider how inducements paid to the firm are regulated under MiFID.

Art. 21 lett. e) of the L2 Directive lists among the situations which should be regarded as giving rise to a potentially detrimental conflict of interest the fact that "the firm or [a relevant] …

[25] A relevant person thereof or a person directly or indirectly linked by control to the firm are equalled to the firm.

[26] Those paid by the firm are a matter of how clients' monies are used: *infra*, IV.2.1.

person receives or will receive from a person other than the client an inducement in relation to a service provided to the client ... other than the standard commission or fee for that service"[27].

Under art. 26 of the L2 Directive firms are considered in breach of their duty to act honestly if, in relation to the provision of an investment or ancillary service to the client, they are paid any fee or commission.

This does not mean that all inducements are prohibited where they come from third parties. These are lawful if the two following conditions are (cumulatively) satisfied. First, their amount should be disclosed to the client; if this is not possible, at least the method for calculating that amount should be[28]. Such disclosure can, at the firm's discretion, be provided in essential terms, safe for the duty to disclose further details upon request[29].

Second, inducements should be designed to enhance the quality of the service provided and should not impair the compliance with the duty to act in the clients' best interest.

The disclosure duty serves two purposes: in lack of a pre-determination of which inducements can be lawfully received, clients' disclosure can trigger market discipline into the matter: in the FSA's view, it would "encourage firms to accept only those benefits for which they can demonstrate value and relevance of the benefit to the client"[30].

Also, if one agrees with what said above, that despite the intermediary's advice client retain the right to freely choose, the rules mandating the disclosure of inducements contribute in the creation of the clients' awareness and informed consent.

Nevertheless, the disclosure strategy embedded in art. 26 seems to serve little purpose. Since it is coupled with rules prohibiting some inducements, the information which reaches the client refers to inducements which fulfil pre-determined benchmarks (coherence with a policy which gives priority to the clients' interest and ability to enhance the quality). If these are fulfilled, the client could – and should – do nothing more than always give her consent.

What should be understood by inducements which enhance the quality of the service provided is hard to tell. The last part of the sentence, referring to the clients' best interest, is coherent with the general aims of the regulation on investment services, and to its objectives of client's (confidence) protection. But when it requires inducements to be designed as to enhance the quality of the service provided, one could legitimately ask whether this does not go beyond what such regulation can control for[31]. Apparently, it puts in the hands of the regulator the starting of a race to the top on the quality of services

[27] In its 2004 advice on art. 21, CESR suggested to mention the existence of fee-sharing arrangements (such as fee rebates or soft commissions) among the cases possibly giving firms the incentives to favour its own or another person's interest above that of the client. Nevertheless, such explicit indication is not included in the final level-2 measures: CESR (2004a), p. 43.

[28] CESR (2007e), p. 9, has refrained from developing detailed guidance on the content of the summary disclosure, holding that no suggestion could fit all circumstances and situations.

[29] CESR(2007e), p. 9, confirms the need for a mere summary disclosure of the terms of the arrangements on the fee, commissions and non-monetary benefits.

[30] FSA (2006d), Annex I, § 2.13, p. 11. Nevertheless, in the same Consultation Paper (§§ 6.23 and 6.31, pp. 32-33), the British Authority also admits that clients' ability or willingness to understand the information is not a given, even for non-retail businesses, to which the disclosure obligation has not been extended.

[31] All in all, the provisions are wider than the ones previously in force in some member states. In the UK, for example, the prohibition only referred to the benefits likely to conflicts to a material extent with any of the firm's duties: FSA(2006 cp 19 reforming), § 6.29, p. 33.

The wording of recital 39 of the L2 Directive testifies that the regulator was aware of this: it stipulates that, in the provision of investment advice or general recommendation, if the firm receives a commission and the circumstances are such that the provision of the service is not biased by it, there is a presumption that the commission enhances the quality of the advice[32]. This presumption avoids the need to verify whether the quality of the service is actually enhanced. Nevertheless, being clearly stated as an exception to the rule, it could end up reinforcing the principle and, in the end, the need for commissions which both do not threat the protection of the client's interest, and enhance the quality of the services.

CESR has intervened on this point, stating that it is sufficient for the "payment or receipt to benefit another client or groups of clients apart from the individual client receiving the service"[33]. As examples of what should be understood to enhance quality of the services, the Committee mentions: inducements which allow for a wider range of products to be offered to investors; inducements offered to intermediaries which grant after-purchase assistance to their clients; inducement provided to an intermediary offering investment advice.

Reference to investment advice was indeed necessary in the light of recital 39 above. But the Committee lost an occasion for stressing the obvious threat inherent to the provision of advice: it can be used to direct the clients' investment toward the instruments of the producer which grants the higher fees, so that coupling inducement with the provision of advice can be particularly dangerous to investors' interests. The condition that inducements should allow for a wider range of products to be offered to investors is not particularly stringent. Provocatively, one can argue that all inducement serve this purpose and authorities should be required, on a case by-case-basis, to prove the contrary by showing, for example, that the instruments 'induced' is not sufficiently different from those already circulated to be lawfully backed by the provisions of inducements.

Instead, all inducements are allowed when they enable or are necessary for the provision of investment services (for example custody costs, settlement and exchange fees, regulatory levies or legal fees are among these inducements) and by their nature cannot give rise to a conflict with the firm's duties (art. 26 lett. c) of the L2 Directive).

A dispute has been going on as to the exhaustiveness of the list, ending up with CESR backing a strict approach. States pointed out that the concept of payments 'necessary for the provision of a service' is not a pre-determinable one, and that justifications could be found to include the widest range of payments.

CESR has intervened making clear that even the receipt of a standard commission of fee can be an incentive to act other than in the client's best interest. This clearly happens when "there are differentials between the fees offered by different third parties", which gives rise to products biases. But also when only one fee is on offer, there is a risk of transactions biases, since the intermediary might be tempted to recommend unnecessary transactions to generate additional fees[34]. On the awareness that these cases are extremely hard to detect, the Committee has ended up adopting a strict interpretation of which fees can be considered necessary for the provision of

[32] For the provision of investment research there is another exception in recital 32 of the L2 Directive which I will consider *infra*, V.3.

[33] CESR (2007e), p. 7.

[34] CESR (2007e), p. 4.

services: it does not consider as falling in the list of art. 26 lett. c) of the L2 Directive any items that "are not of a type similar to the costs it mentions"[35].

Furthermore, States have suggested to loosely interpret the concept of payments *in relation to the provision of services to clients* (see art. 21 lett. e), *supra*), to give due consideration to the fact that product management companies might make payments to investment firms to remunerate them for the services the management companies receive (those of brokerage or those of distribution), so that they do not conceptually fall under the category of inducements.

The Committee has not denied this possibility, but has underlined that it is hard to argue that these types of payments have no connection with the provision of investment services to clients "when such a payment has some dependence on or relationship with current, past or perspective acquisitions by clients"[36]. Reading between these lines, CESR aims at backing the strictest view that all payments from a management company to an investment firm might well be an inducement.

It is hard to predict to what extent, under this regulation, inducements will 'escape' these provisions when dangerous to the clients' interest, especially when structured in a complex way so as to disguise what they are really paid for, while being hindered when useful.

More work has to be done on the matter of inducements: for example, it is not clear whether art. 26 of the L2 Directive can 'capture' the practices of softing[37]. Softing takes place where a broker offers to the portfolio management for which it acts additional services, such as investment research and data services, and is remunerated for that by third persons, so that for the manager it amounts to a pure benefit in exchange for putting business through the broker.

Some respondents to the CESR'S consultation paper[38] highlighted that, despite looking similar to inducements from the perspective of conflicts of interest, they might be "a market outcome of competition". They allow for *ex post* adjustment (in form of services rather than cash) of the price paid and allow the conclusion of bargains at unit prices although the supplier has high fixed costs and the value or volume of services consumed is *ex ante* unpredictable[39].

They concluded that not all the national practices of softing could be effectively addressed by MiFID, and that the named article does not altogether prohibit them. In its 2007 feedback statement CESR itself did not seem satisfied that a level-playing field should be mandated on this matter, and has planned to conduct further work[40].

Instead of going down the intricate path of which inducements can lawfully be received, there are two other ways of treating inducements. First, one could simply read the suitability rule as an obligation intermediaries have to fulfil irrespectively to the inducements they receive: conclude either that when they provided "induced" products, these have to be the most suitable among the suitable, or that the induced service have to be at least as suitable for the client as others are.

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[35] CESR (2007e), p. 4.
[36] CESR (2007e), p. 5.
[37] More on this, *infra* IV.5.
[38] CESR (2006), p. 16.
[39] IMA (2007), p. 6.
[40] CESR (2007e), p. 12.

These critiques hold the more true if only one considers that the regulation of inducements is not neutral to the market structure of certain States. Let us analyse these provisions in the light of what happens in the business of collective investment schemes.

MiFID does not apply neither to collective investment undertakings nor to the depositaries and managers of such undertakings (art. 2 (1) lett. h) of the L1 Directive). Nevertheless, units in collective investment undertakings are listed among the financial instruments (Annex I Section C of the L1 Directive), and can therefore become MiFID-relevant when intermediaries circulate them through the provision of services. The placement of units in collective investment schemes, the provision of advice as well as the reception and transmission of orders over them, fall under MiFID's rules.

Intermediaries often happen to be a channel of distribution for collective investment undertakings, which pay the distributors rendering back part of the management fees charged to investors. This constitutes a recurring practice, easily following under inducements.

In some countries, such as Italy, investment companies offer units in collective investment schemes mostly – is not exclusively – through the counters of the banks of their group[41], in order to take full advantage of branding and lock-in effects. The remuneration is structured with the originator returning commissions to the distributor. In this chain originator-distributor taking place within the same group it is not the commission structure which creates the highest threat of conflicts' exploitation, but the interest as a group and the objective of cross-subsidising businesses within it. Banks could therefore have the incentive to place units beyond what would be appropriate for the clients irrespectively to the inducements paid. A regulatory light-touch approach to inducements could instead allow different producers, which do not belong to the group, to compete for the distributing channels, increasing the number of products offered to investors.

This debate is well-known in the UK, where the FSA has stated: "the sale of retail investment products in the EU is driven by intermediaries, independent financial advisors (IFAs) in the UK or bancassurance chains in continental Europe. The vast majority of retail investment products are sold through these channels. Product promoters compete to gain access to these channels and pay the distributor remuneration in the form of a commission embedded in the product"[42]. Hence, the quality can be enhanced by the payment to the firm from the part of the product originators, in that is ensures the that the fullest range of service can reach investors.

#### IV.2. Exploitation of clients whose monies are not put to their benefit.

The second form of exploitation MiFID wants to avoid is the one which takes place when the client's monies are not put to her benefit. The fact that the client pays for the services received is of course necessary. But her interest is put in the background where she is not given the possibility to chose on the basis of what she pays or, in other words, know and accept the costs of the services and instruments.

The first safeguard against this are the provisions on costs' disclosure. The regulation on this point should take into consideration the fact that the cost structure can also be made less

[41] See Rossi, Gariboldi, Leggieri, Russo (2008); Draghi (2008).
[42] European Commission (2008b), p. 10.

transparent by agreements between the firm and the provider, on which basis the former pays monies to the latter, and this costs are transferred onto the client.

### *IV.2.1. Information about costs and associated charges.*

Art. 33 of the L2 Directive requires firms to provide the client with information about costs and associated charges. This provision supplements those of arts 19 (7) and (8) of the L1 Directive and 33 of the L2 Directive. Art. 19 obliges firms to "establish a record that includes the document[s] … agreed between the firm and the client that set out the rights and obligations of the parties, *and the other terms on which the firm will provide services …*", and to give the client "adequate reports on the service provided … [which] shall include … *the costs associated with the transactions and the services …*" (emphasis added).

Art. 33 itemises the content of such disclosure: it refers to the total price to be paid by the client, including all related fees, commissions, charges, expenses etc. Pursuant the general rule of art. 29 (2) of the L2 Directive, this information shall be provided in good time, before the provision of the service, so that the clients have a reasonable possibility to consider it for their decision.

The costs to investors can be rendered more obscure in a number of cases which commonly happen in the business practice. For example, when a broker provides to the intermediary services other than the order execution and the commissions paid by the client cumulatively remunerate them (bundling). Or when the additional services are paid for by the firm, but this recovers the expenses from the client, charging higher fees[43]. On this respect, it is not clear whether art. 33, last sentence, of the L2 Directive is sufficient to make clarity as to hidden costs, since it requires that only the commissions charged by the firm shall be itemised separately.

A higher degree of transparency could be obtain applying the rules on inducements, but it is debated whether they apply. Art. 26 does not only capture the monetary, but also the other types of and other benefits which are paid by the firm to third parties. Nevertheless, lett. a) exempts those which end up being paid by the clients themselves, or by a person on behalf of the client[44]. In case the costs of these services are recovered from clients, them no prohibition applies, but the rules on information do. If the costs are not recovered from the client, these agreements risk fall under the strict – but blurry – test of whether they enhance the quality of the service.

### *IV.2.2. Overtrading.*

Another way in which the client's monies is not put to its benefit arises from overtrading, i.e. the accomplishment of a number of operations on her portfolio which has no justification from

[43] As the abovementioned case of softing, this practice in the end ensures goods and services to the intermediary in exchange for having provided business to a broker.

[44] Under CESR's level 2 recommendations (CESR 2007e), p. 6, "for an item to be considered … paid or provided by the client or a person acting on behalf of the client it is not sufficient just for the economic cost of the item to be borne by the client. Nor is it sufficient that the 'person' is acting on behalf of the client relating to the service; it is necessary for the person to be acting for the firm's client in relation to the payment service provided to the client". See De Rossi, Gariboldi, Leggieri, Russo (2008) stressing the different focus of arts 21 and 26.

her point of view, since it is disproportionate to her financial capability, to her level of risk aversion or, simply, to the result one can reasonably expect from them.

The firm has a two-fold interest in this: either that of gaining more commissions, if its remuneration is made proportional to the number of transactions accomplished; or that of receiving monetary or non-monetary benefits from the broker in exchange for posting the orders.

In the first case, the suitability rule applies. Recital 57 of the L2 Directive guides intermediaries in this respect, since it states that transactions should not be regarded in isolation when they are undertaken in the context of portfolio management. Indeed, transactions might be unsuitable if they would result in unsuitable portfolios. to also ensure that clients can exercise a monitoring on the firms' choices.

The second case arises with the softing and bundling agreements described above. In 2006, the FSA found out that firms tended to over-consume associated services, (such a investment research which can be provided by brokers along with execution, or by third parties), and to over-trade to generate soft-commission credits. In both cases, a market failure was detected, in terms of accountability to customers about how commissions were spent and for what they were charged[45]. Framing these practices under the problem of how clients' monies are used, loosens up the connection with the inducement provisions.

As mentioned above, and confirmed by CESR in 2007[46], it is unclear to what extent these practices are subject to disclosure requirements or considered unlawful at the EU level.

### IV.3. Conflicts of interest exploitation at the point of execution.

After the choice of the service or the instruments on which to act, the way in which clients' order are executed can put the clients' interest at stake: the timing and the choice of the broker bear particular importance. This concern is mainly addressed by the rules on best execution and order handing.

Also, the firm can impact on the price at which its clients buy or sell securities through its operations, or those of their employees. Front-running the clients' orders means operating on proprietary positions on the knowledge of these orders: both the firm or its employees can sell before executing the client's big sell order, in order to avoid that the consequent downturn of the investment's value does not affect the own portfolio; they can buy before executing the large buy order to profit from the upwards shift in price[47]. The reason why this substantiates a conflicts of interest exploitation is that when the client is willing to buy, she will only be able to do it at the higher price determined on the market by the previous buy order of the firm, and when she is willing to sell, the proceedings she will able to make are decreased by the previous sell order posted by the firm. Such behaviour normally happens with big (professional clients') orders due for immediate execution[48]. With small individual (retail) orders, the investment firm is not likely to

[45] FSA (2006d), Annex I, §§ 10.12 ff., p. 56.
[46] CESR (2007e), p. 12.
[47] See Boatright (2000), p. 211.
[48] Consob (2007), 84.

gain sufficiently from the exploitation. Nevertheless, the same as with professional clients can happen when the firm gives the same buy advice to a sufficient number of (even) small clients.

### *IV.3.1. Best execution.*

The possibility to obtain the best possible result for transactions under the multiplication of trading venues entailed by MiFID has been highly controversial. MiFID repeals the concentration rule, and imposes Member States to allow execution of transactions otherwise than on regulated market, thereby potentially scattering the trading intentions which cease interacting for the formation of uniform execution conditions. If orders are not consolidated, transparency is put at stake as well as comparability, and no venue can be considered a benchmark against which the quality of execution can be confronted. Although regulated markets might remain incumbent venues for execution, the price formed thereon can easily lose of representativeness, since the creation of alternative venues skims some orders away from them.

MiFID's best execution rule can therefore not have the same meaning as the same rule adopted by some Member States during the pre-MiFID era.

The best execution obligation is a matter on which the Commission explicitly held the ISD's minimum harmonisation insufficient: "while there is a shared understanding that 'best execution' amounts to an obligation to obtain the best price reasonably available for the client, Member States differ in terms of the procedures used to give effect to this objective"[49]. Nowadays, best execution has to be interpreted as a multi-dimensional concept, referring to the possibility of obtaining the most tailored service at the lowest cost.

This is the meaning conveyed by arts 19 and 21 of the L1 Directive and 44-46 of the L2 Directive. Firms shall execute clients orders so as to obtain the best possible result for them. By clients orders one should understand transactions based on a client's request, execution of orders by dealing as agent, against own proprietary positions or as a riskless principal, execution of decisions to deal by a portfolio manager directly with an execution venue[50].

Pursuant art. 21 of the L1 Directive investment firms shall 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". The assessment of the relative importance of such criteria is left to firms, which should nevertheless take into consideration the characteristics of: the client and its order; the financial instruments; the execution venues to which it can be directed (art. 44 (1) of the L2 Directive).

Nevertheless, where dealing with retail clients a pre-eminent importance should be devoted to the total consideration, "representing the price of the financial instrument and the costs related to execution, … [including] the expenses incurred by the client …" (art. 44 (3) of the L2

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[49] Commission (2000), p. 9, footnote 12.

[50] Commission's working document (2007) annex to CESR (2007a), pp. 19 ff. On the contrary, proprietary trading by quoting on the basis of a 'request for quote' should be excluded, as well as other cases which do not openly fall under the aforementioned possibilities, unless it appears that the client legitimately relies on the firm to protect her interest in relation to the pricing and other elements of the transactions (speed, likelihood or execution and settlement).

Directive). The importance of costs for retail clients is further stressed by art. 33 of the L2 Directive, which requires, as seen, firms to provide detailed information about them[51].

CESR has underlined the flexibility of the total consideration factor: implicit costs might take the precedence over explicit ones even for retail client, "if they are instrumental in delivering the best possible result in terms of the total consideration"[52].

For this flexible concept of best execution, MiFID has been widely hailed, and in particular the fact that not only price but also the possibility of obtaining the most tailored service at the lowest cost is an index of best execution. Reference to price can sometimes be tricky: as *Ferrarini* notices, "working a larger order 'patiently' may save the costs deriving from this order's market impact the generate the best net price". Also "speed of execution may be important when the costs of an adverse market movement are likely to be great. Likelihood of execution, which depends upon the 'depth' of liquidity at a given venue, is also relevant"[53], given that there is no point in considering the best price where the "execution venue in question is unlikely to complete the order"[54].

To fulfil the best execution rules, firms have to establish execution arrangements, to be periodically monitored and corrected[55]: these are lists including, for each class of instruments, the venues which enable to obtain the best possible result for each class of instruments on a consistent basis. Following CESR, they should adequately differentiate professional from retail clients and types of clients orders[56].

These lists have to be formalised in a order execution policy[57], they should include information about the different venues on which the firm intends to act and the reasons for including them[58] and "an account of the relative importance, or the process for determining the relative importance, the firm places on the best execution factors"[59].

The policy should be disclosed to the client for obtaining her prior consent[60], in good time prior to the provision of the service (art. 46 (2) of the L2 Directive). Clients can also ask the firm to

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51 Ferrarini (2007), p. 409, confirms that a narrow definition of best execution is "an easy test to apply for retail clients wishing to monitor the quality of order execution", who can find in the price an easy parameter to assess performance.

52 CESR (2007a), p. 8. Speed, likelihood of execution and settlement, market impact of the order are among the factors which determine implicit costs, costs other than the expenses directly incurred in by investors. Among the implicit costs one can also mention the operation, timing and missed-trade opportunity costs: see BME consulting (2007), p. 49. Some scholars fear that price considerations can take the precedence for other classes of clients as well. As Casey, Lannoo (2006), pp. 5-6, put it, "investment firms may decide to go for the surest option, i.e. to select trading venues solely on price-based criteria, thereby removing flexibility as to non-price considerations regarding the quality of execution".

53 Ferrarini (2007), p. 407.

54 FSA (2006a), p. 17.

55 Art. 46 of the level-2 Directive. For the content of the policy see art. 21 (3) of the L1 Directive.

56 CESR (2007a), p. 7.

57 The terms 'execution arrangements' and 'execution policy' are often used together by the European regulation. As CESR (2007a), p. 6, interprets it, arrangements are the instruments employed by an investment firm to obtain the best possible result, and the policy is a document describing the most important elements of those arrangements.

58 As confirmed by recital 66 of the L2 Directive, firms are not required to include all available execution venues.

59 CESR (2007a), p. 6.

60 CESR (2007a), p. 11.

demonstrate that the policy has been respected (art. 21 (5) of the L1 Directive), but there is no unanimous thinking on whether the policy's variations need to be approved[61].

Thereinafter, the firm can execute the orders by choosing one of the venues listed[62]. In exceptional circumstances a firm may use a venue not listed, "for example, on a provisional basis or to accommodate a client request to trade in an unusual instrument"[63].

To ensure full verifiability, the L2 Directive also requires, for the benefit of retail clients, prompt and detailed reporting of the orders executed, which includes, among other things, venue identification, total consideration, total sum of commissions and expenses charged (art. 40).

When the firm transmits to (or places orders with) other entities for execution, MiFID aims at striking a balance between the need to avoid a duplication of efforts and that to ensure the exact compliance. To this end, it makes it the firm's responsibility to ascertain whether the other entity is subject to MiFID; in the negative, the firm should ensure that the third party binds itself (contractually) to respect the best execution rule[64].

This mechanism puts together two regulatory strategies: that of allowing intermediaries to use their expertise in choosing the venues to include, and that of making (both *ex ante* and *ex post*) the choice verifiable for investors.

Retail clients' need to understand how the firm deals with the best execution obligation is stressed by CESR. The Committee suggests that firms: inform retail clients as to the relative importance assigned to the best execution factors and to the process for determining best execution; stress the list of venues on which they place significant reliance; issue a warning to the clients regarding the use of specific venues[65].

True is that there is mixed evidence as to the ability and willingness of the retail clients to verify that the execution provided matches the firm's policy, or to attach any value to the post trade reporting as to the venues used, and some Authorities have put more emphasis on the "benchmark approach"[66] embedded in the directive, where it obliges firms to take into consideration pre-determined verifiable factors for the choice of the venues.

Nevertheless, the rule does not aim at protecting the individual investor. What it pursues is coherence between the firms' case-by-case decisions and the general assessment of the execution possibilities undertaken by the firm beforehand: recital 66 of the L2 Directive requires best possible result *in accordance with the policy*.

As CESR acquaints "firms … are not under an obligation to obtain the best possible result for each individual order; rather, they should apply their (execution) policies to each order with a view to obtaining the best possible result in accordance with the (execution) policy"[67].

Some scholars have described the rule stating that it sets up a supervisory duty of organisation thus only demanding the investment firm to set up a suitable concept of best execution"[68].

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[61] The FSA (2007b) holds for the negative.
[62] CESR (2007a), p. 6:
[63] CESR (2007a), p. 6.
[64] CESR (2007a), pp. 12-13.
[65] CESR (2007a), p. 10.
[66] See FSA (2001), 2.
[67] CESR (2007a), p. 6.

One should not neglect that art. 44 (2) of the level-2 Directive allows clients to issue specific orders which overcome the regulatory criteria and bind the firm to its fulfilment, so that compliance with the best execution rule follows the execution of the specific order. Nevertheless, some potential abuses were highlighted: the firm might ask for instructions – which it influences – for each transaction. As a consequence it is held that "the execution policies can only serve as a starting for determination of the duties of the client information in such cases"[69].

Compliance with best execution is particularly hard to assess: not only because of the multiplication of venues mentioned in the outset. Also because financial innovation fosters the development of instruments tailored to the most diverse needs, so that the best execution of the orders one of them can hardly be the benchmark for evaluating the execution on the other[70].

Timeliness of execution is also an interest of clients, in order to avoid that trading possibilities are lost while the intermediary holds clients' monies or instruments to its sole benefit. The named rule on best execution requires to firms to include in their consideration of the best execution policy also circumstances such as speed and likelihood of execution. But timeliness is also addressed by more specific provisions.

### *IV.3.2. Execution of the firm's and clients' orders.*

Following art. 22 of the L1 Directive and art. 47 of the L2 Directive firms have to implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to the trading interests of the investment firm. This provision aims at comparing the quality of the execution with respect of the handling of the firm's own transactions. To fulfil this obligation firms shall have in place an order allocation policy, which should provide for precise terms for the fair allocation of aggregate order.

In fact, client's orders cannot be aggregated with the firm's own transactions unless, it is unlikely that it will work overall to the disadvantage of any client, provided that each client has been informed that the effect of aggregation may work to its disadvantage in relation of a particular order[71].

The allocation of aggregated firm-clients' orders shall not be detrimental to the client. To ensure this, if aggregated orders are only partially executed, firms shall allocate the related trade to the client in priority. However, it can also allocate it proportionally to its own trade, if it can prove that without aggregation, the client would not have obtained such favourable terms as she did (art. 49 (1)-(2) of the L2 Directive).

The allocation shall in this case take place in conformity to the order allocation policy: as it was under the execution policy, the compliance with a 'reasonable', pre-determined policy risks

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[68] Barry, Bracht (2008), p. 1183.

[69] Barry, Bracht (2008), p. 1183.

[70] Recital 70 of the L2 Directive accounts for this: "Best execution obligations should therefore be applied in a manner that takes into account the different circumstances associated with the execution of orders related to particular types of financial instruments. For example, transactions involving a customised OTC financial instrument that involve a unique contractual relationship tailored to the circumstances of the client and the investment firm may not be comparable for best execution purposes with transactions involving shares traded on centralised execution venues".

[71] Art. 48 of the L2 Directive. See also CESR (2005b), p. 39.

bearing more importance that the attainment of the favourable terms for the client which might become possible on a case-by-case basis. Conversely, not allowing for an aggregation and allocation which benefits firms without triggering enhanced terms for clients is too restrictive.

After the level 1 measures were adopted, and before the implementing measures, it was argued that the obligation does not apply to portfolio management, since in this case the firm does not deal with clients' orders, and does not execute it when it indirectly accesses execution venues[72]. Despite the Commissions' undertaking to eliminate ambiguity as to the application of this obligation to portfolio management as well[73], after the position expressed by CESR[74], the L2 Directive still features ambiguous references to *client's order* and the *carrying out* thereof[75].

If one considers that the rule only applies to the timing and allocation of orders, not to the timing and allocation of the decisions resulting in those orders, the application of the rule appears to be desirable for portfolio management. Manager could decide to order for the account of its clients to take advantage of the opportunity of aggregating the order with its own. It this is not prohibited under the rule, prohibiting the firm from taking advantage of it at the expenses of clients would eliminate the incentives to pursue self-interested orders.

#### *IV.3.3. Bundling and softing?*

The practices of softing and bundling bear importance also with respect of the possibility that the choice of the broker for the order execution is made having the sole interest of the firm in mind, and not that of the client. Through these agreements intermediaries obtain additional services, so that they could be tempted to convoy the order to the broker which ensures the highest number of by-services, irrespectively to whether it is the best executor for the order.

Art. 45 (2) of the L2 Directive recalls the duty of art. 19 (1) of the L1 Directive, and emphasises that firms have to act in accordance with the best interest of the clients even when they transmit orders for execution to other entities. Art. 45 (4) mirrors the best execution obligation on this matter. A policy must be set up, monitored and revised to identify the entities which allow for the best execution, taking the factors of art. 21 of the L1 Directive and their relative importance as in art. 44 of the L2 Directive into consideration.

In light of these safeguards, one can question whether prohibitions of softing and bundling (eventually as unlawful inducements) add further protection, provided that the choice of the broker is realised in accordance to the client's best interest and is not merely procedurally consonant with the execution policy.

### IV.4. Detriment to the client with a common agency set-up.

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[72] Kruithof (2005), p. 38.

[73] European Commission (ESC/23/2005), available at http://ec.europa.eu/internal_market/securities/docs/isd/dir-2004-39-implement/esc-23-2005_en.pdf, art. 18 (2).

[74] Cesr (2005a), p. 18.

[75] *Kruithof* (2005), p. 38, shares the CESR's concern: "this ignores the fact that poor or unfair execution has an adverse impact on portfolio performance", CESR (2005a), p. 18.

As pointed out in the first chapter, peculiar types of conflicts of interest can be found in common-agency settings. Depending upon whether the principals stand on the same or on opposite sides of the market, the types of conflicts differ.

Two clients giving orders for execution, instead, stand on the sale side of the market, and the intermediary might further the interest of one at the expenses of the other.

This is mainly a conflict which arises at the point of execution. Theoretically, it could also arise at the point of choice, insofar as one client is advised to undertake the transaction which is more beneficial to another client's existent portfolio or envisaged transactions. Nevertheless, retail clients' orders are too modest to allow for a price shift of which other clients could benefit and, in case of a contemporary sufficient number of small orders could lead to this result, the prohibition of misuse of clients' pending orders applies.

Instead, at the point of execution, exploitation can take place[76] and since there are no different departments to shield through internal barriers, MiFID addresses this with the client order handling rule, which applies to aggregation of firm-client, as well as client-client orders.

### *IV.4.1. Conflicts of interest exploitation at the point of execution.*

#### *IV.4.1.1. Client Order Handling Rule.*

Following this rule firms have to implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders. This is to ensure that the execution of otherwise comparable client orders takes place in accordance with the time of their reception by the investment firm, so that the interest of one client is not postponed to that of another client (art. 22 of the L1 Directive and art. 47 of the L2 Directive).

The concept of 'comparable' orders dramatically changes the scope of these provisions. Pursuant recital 78 of the L2 Directive "client orders should not be treated as otherwise comparable if they are received by different media and it would not be practicable for them to be treated sequentially". This leaves in the hands of firms to decide when the rule applies.

After this determination, the firm shall ensure that orders are promptly and accurately recorded and consequently allocated (art. 47 (1) lett. a)).

In the L2 Directive, the order handling rule, and in particular the principle of 'prompt execution' has indeed exceptions. One is if the characteristics of the order or the prevailing market conditions make it impracticable, or against the client's interest (art. 47 (1) lett. b)). This exceptions root in market efficiency and client interest reasons.

Instead, the exception of art. 47 (1) lett. c) allows for the possibility that the firm encounters material difficulties in the proper carrying out of orders. It stipulates that the intermediary is exempted from responsibility under the condition that it immediately informs the client of this circumstance. This exemption takes into consideration firms' technical difficulties and mitigates the benchmark approach embedded in the rule.

[76] Blair, Walker, § 10-138. CESR (2005d), p. 43.

From investors' point of view, the existence of these parameter, as well as the records the firm has to keep with respect of the orders received and executed would allow control over the intermediary's behaviour.

For aggregation and allocation the same considerations as above apply: as a rule, client orders cannot be aggregated with those of other clients. Nevertheless, CESR expressed the view, in its technical advice, that "the potential benefits of aggregation for all clients … outweigh the risk that aggregation may, on occasion, work to the disadvantage of a specific client"[77]. Hence, the possibility of client-client order aggregation is allowed if it is unlikely that it will work overall to the disadvantage of any client. The requirement of client's information applies as well. In practice, aggregation is allowed and firm bears responsibility of showing that it has duly evaluated the unlikelihood of clients' detriment in its aggregation policy, and he policy has been respected.

### IV.5. Some Comments for softing and bundling.

Softing and bundling have been considered throughout the Chapter as they create different threats to the clients' interests. In the first supranational discussions on their lawfulness, they were treated under the matter of inducements. Later on, this idea has been fiercely opposed by industry representatives, which highlighted their benefits and the fact that they are conceptually different from inducements. CESR and the Commissions have not spoken the last word on this, and the fact that they endeavour to conduct further works is a sign that their realm has to be established yet. For sure, the possibility that they fall under rules other than those on inducement has remained in the background.

So far, some States have retained their national rules, other have enacted level-3 provisions which clarify the content of the rules on inducements when applied to those practices. The analysis of the UK and Italian choices on this matter exemplifies how the uncertainty shown by the supranational regulator is likely to hamper the creation of a truly levelled playing field.

The UK, which had previously asked to retain its previous regime under art. 4 of the L2 Directive[78], has afterwards retained its own regulation[79].

Under the Handbook[80], firms acting as investment managers and executing clients' orders relating to designated investments face limitations with reference to the types of services which they can purchase with the commissions given by clients for the dealing activity. They can only purchase from brokers[81] additional goods which fall under one of the two categories: those which can be reasonably considered as related to the execution of trades; those related to the provision of research.

[77] CESR (2005b), p. 39.

[78] FSA (2006d). Art. 4 of the L2 Directive allows States to enact or retain more stringent requirements under a number of restrictive conditions, such as that the requirements are justifiable in light of specific needs of the national market.

[79] FSA (2007h), p. 110.

[80] See COB 7.18.15. R.

[81] The regulation does not apply to the case where investment managers produced such additional services internally.

The former are services linked to the arrangement and conclusion of a specific investment transaction, provided between the point at which the investment manager makes an investment or trading decision and the point at which the investment transaction is concluded (See COB 7.18.4. E). The latter comprise research capable of adding value to the investment or trading decision by providing: new insight about the customers' portfolio; original thought, deriving from the critical and careful consideration and assessment of new and existing facts; analysis or manipulation of data to reach meaningful conclusions. It should not merely repeat or repackage what has been presented before, or state what is commonplace or self-evident (COB 7.18.5.E)[82].

In all cases, the regulator also requires that such additional goods and services reasonably assist the provision of the execution service, and are not likely to impair compliance with the duty to act in the best interest of the customer (COB 7.18.1R ff.).

COB 7.18.12. R also mandates prior and periodic disclosure of such arrangements and the envisaged goods and services in a timely manner, and in any case once a year. The prior disclosure should explain generally why the firm might find it necessary or desirable to use dealing commission to purchase goods or services, with reference to the practices which are more common in the markets in which it does business on behalf of its customers (COB 7.18.14. G).

These rules appear to be more stringent than those under the inducement provision of MiFID, in that they introduce sharp limitations. They emphasise the need for transparency, while repealing the requirement that inducements enhance the quality of the service which – as noticed by the industries' representative in response to CESR, is the most problematic to apply.

In Italy, Consob has consulted on level 3 provisions[83] which explain how MiFID's rule on inducements shall be understood and applied to the case of soft commissions. The authority explicitly addresses the possibility that the manager is provided research services from the broker; it expresses the view that, since research is essential for any management activity and is therefore already remunerated through management fees, research can be lawfully received as soft commission only under some restrictive circumstances.

First, it has to embed an added value as compared to the research normally and automatically provided. For example, it can be complementary to this latter, and it shall always be rigorous, significant, original. Also, there must be a strict relationship between the broker's operational competence and the content of the research. Thereby, Consob explains what should be understood under the European wording of "inducements which enhance the quality of the service provided".

Firms shall disclose to clients the economic importance of such research for the accomplishment of the management activities, and all circumstances modifying the information previous give shall also be made clear.

The fulfilment of the best execution duty shall not be hampered because inducements are received. When intermediaries draw up the transmission policy[84], they have to explicitly mention

[82] As a difference with the European regulation, what is remunerated here is the advice provided to the investment firm by a third party, and not that provided by the firm to its clients. It is indeed this latter which triggers concerns: it can be used to direct clients toward the services of a provide with which the intermediary has softing agreements.

[83] As required by recital 12 of the L2 Directive in order to avoid that the uncertainty of the regulatory regime might reduce efficiency. Consob (2009).

[84] The equivalent of the best execution policy when firms do not execute transactions themselves, but post them to other entities for execution.

the existence of inducements, the costs which they add to the execution, and the benefits which are reasonably obtained though them.

**Conclusions.**

All possible disloyal exploitative behaviours of the firm or its employees fall under the lenses of MiFID, which considers both agency and common-agency situations. Its detailed conduct of business rules apply to prevent a number of exploitations, namely those having their occasion in the choice of the investment, in the management of the clients' monies, in the execution of the orders. This whole of rules appear to be the default regime mandated for retail clients.

The regulation MiFID is fairly procedural (with the best execution and client order handling rules), considerably paternalistic (with the suitability and appropriateness tests), not clear as to its aims (with the identification of unlawful inducements). Its rules on information should put the investors' aware decisions in the foreground, but the way in which they are devised sometimes frustrates this aim.

In front of these failures, two questions arise. First, to what extent the application of general clauses of fairness, professionalism, honesty can be of some use in bringing the interest of the clients back to the foreground? And to what extent this is possible under MiFID? Second, to what extent the default system can be opted out? These questions will be addressed in the next Chapter.

# Chapter V

## Conflicts of interest in selected cases – MiFID's responses.

Proprietary trading, portfolio management and corporate advice are the three key areas on which CESR has proposed to put particular attention when regulating conflicts of interest[1].

It is therefore useful here to assess whether MiFID provides for specific and tailored rules for these activities.

### V.1. Systematic internalisation.

The term internalisation describes the practice by which investment firms (the internalisers) execute clients' buy and sell orders on financial instruments by matching them with their own proprietary positions[2]. In this way, transactions are concluded outside a regulated market or a Multilateral Trading Facility (MTF)[3], and internally to the firm, which becomes a new trading venue while dealing on the client and on own account.

In MiFID's nomenclature it takes place when firms deal 'on own account' on a wide range of financial instruments[4], by executing (retail as well as professional[5]) clients' orders outside a regulated market or an MTF (art. 21 of the L2 Regulation). It does not constitute a service *per se*, but it is the results of the joint performance of two services: dealing on own account and execution of orders on behalf of clients. When it is accomplished on an "organised, frequent and systematic basis" [6] (Art. 4 (1) n. 7 of the L1 Directive), specific rules apply[7].

[1] CESR (2004d), p. 1.

[2] See Ferrarini, Recine, (2006), p. 3. Scholars also talk about internalisation when the order of a client is matched against one of another client. They normally name these two possibilities "dealer-based internalisation" and "in-house matching" respectively, but treat them together, under the common heading of "internalisation". A more limited number of works claim that there is a need to keep the two distinguished: Goldfinger (2003), p. 18.

[3] Lee (2002), p. 14, stresses that a significant feature of internalisation is the fact that the order is not exposed to "an exchange or primary market".

[4] See recital 52 of the L1 Directive.

[5] Recital 50 of the L1 Directive.

[6] This means that the activity: has to be made available to clients on a regular and continuous basis; should have a material commercial role; should be carried on in accordance with non-discretionary rules and procedures, by personnel or through an automated technical system assigned to that purpose (art. 21 of the L2 Regulation)

[7] There are exceptions to this: dealing on own account shall not constitute internalisation when it is performed "on an *ad hoc* and irregular bilateral basis with wholesale counterparties as part of business relationships which are themselves characterised by dealings above standard market size" or where "the

The definition shows that this activity implies the existence of conflicts of interest: the counterparty of clients' orders is always the firm with its own portfolio.

As *Sartori* has called it, introducing the status of systematic internaliser, MiFID has codified the position of a professional of conflicts of interest[8]. It is common to read in the literature[9] that internalisation can be dangerous to investors' protection since it offers motive and occasion to unfairly behave towards clients, and in particular not grant them the best execution of their trades.

Firms contextually acting as service providers and trading venues have an interest in retaining the orders for execution in-house, when they have a proprietary interest matching the client's order (for example, if they want to sell an instruments which weighs too much on their portfolio and a client gives a buy order on the same instrument). Investors' interests are exploited when this type of execution does not bring them the best possible result in terms, for example, of price they pay for the transaction[10]. But they also have this interest with, by executing trades at non transparent or inflated conditions, they can retain a higher margin for themselves[11].

MiFID contains many specific provisions aiming at counterbalancing the threats posed by internalisation[12]. For the benefit of individual clients, the pre-trade transparency rule ensures verifiability of the conditions applied for trades. The best execution obligation also applies. Importantly, it contains a rule which addresses the specific risk of exploitation entailed by the internalisation of orders.

### *V.1.1.Price transparency.*

Art. 27 of the L1 Directive lays down the pre-trade transparency rule: investment firms shall publish a quote for the instruments for which they are systematic internalisers. It only applies to shares admitted to trading on a regulated market for which there is a liquid market[13], and only

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transactions are carried out outside the systems habitually used by the firm concerned for any business that it carries out in the capacity of a systematic internaliser" (art. 21 (3) lett. a), b) of the L2 Regulation).

[8] Sartori (2008), p. 6.

[9] Biais e Davydoff (2002), 26.

[10] Sabatini and Tarola (2002), pp. 11 and 20; Alemanni, Lusignani and Onado (2006), p. 202. European Commission (2002), p. 22.

[11] The threat that the clients could be advised to act on certain instruments only because the firm has an interest in it (included a proprietary position which it aims at dismissing) has already been discussed: his type of risk is addressed by the rules on organisation (*supra*, III.1.).

[12] Some measures serve both the market efficiency and the protection of clients, although I merely refer to the latter. Briefly, I shall recall that the multiplication of trading venues (internalisation included) might scatter the orders posted on the same instrument and the information about the conditions at which the players are willing to transact, so that it hinders the possibility that the prices are formed. For these reasons, the measures on disclosure are also devised to take market efficiency into consideration. For the debates on these issues see: Alemanni, Lusignani, Onado (2006); Ferrarini, Recine (2006); Anolli, Bianchi, Venturino (2004); Biais, Davydoff (2002);Köndgen, Theissen (2006).

[13] Art. 27 (1) first subparagraph of the L1 Directive as further specified by art. 22 of the L2 Regulation. The reason for this limitation lays with the fact that internalisation can only be said to worsen the market in terms of liquidity where a liquid market is already in place. To grant uniform application of this principle CESR has published a database of liquid shares for the first time in July 2007, and has improved it following consultation with the market: CESR (2007b) and CESR (2008), accessible at http://mifiddatabase.cesr.eu.

for dealing in sizes up to the "standard market size" (SMS)[14], as defined by Table 3 Annex II of the Regulation.

In compliance with art. 65 (1) of the L1 Directive, on 3 April 2008, the Commission issued a report to the Parliament and the Council on the possible application of transparency rules to securities other than equity. The matter of cash bonds markets was prioritised, especially in the light of the (high) degree of retail exposure to them, but the conclusions have excluded the need for a regulatory intervention at the Community level for broadening the scope of the current transparency provisions. The Commission underlined that Member States can already apply pre-trade transparency requirements to financial instruments and industry initiatives are currently in place to ensure wider availability of information[15]. This conclusion is open to a number of objections, above all that this information would also be necessary to verify whether firms obtain the best execution of their clients orders[16].

The quote mandated by art. 27 has to include the bid and/or offer price, or the price per size, up to the SMS. Moreover, it has to reflect the prevailing market conditions[17], save for non-retail clients, which do not need (as retail clients do) a benchmark to assess the quality of the execution. Apart from these restrictions, firms can decide their quote for each size.

Information shall be made public on a continuous basis during normal trading hours – meaning as soon as it becomes available and as close to real time as possible[18] – in a way that is easily accessible to other market participants on a reasonable commercial basis, and can be updated at any time[19]. One should notice here that the timing of disclosure is not precisely set so that intermediaries are granted considerable leeway, possibly diminishing the impact of the transparency obligation[20]. Nevertheless, firms have strong incentives to publish pre-trade information (and to check on its accuracy), in order to avoid that some orders are lost, or that their quotes are hit or avoided.

### *V.1.2. Best execution.*

With the multiplication of trading venues it is legitimate to ask whether the best execution obligation is meaningful and can be fulfilled, since the orders are scattered, the information about

[14] Art. 27 (1) second subparagraph of the L1 Directive. See also art. 23 of the L2 Regulation. The shares are divided into classes, and the SMS of each of them depends upon the average value of the orders executed for those shares, in comparison to all orders executed in the European Union (art. 27 (1) fifth subparagraph of the L1 Directive).
[15] See International Capital Markets' Association (2007).
[16] With different levels of transparency in the trading venues, the exact fulfilment of the best execution rule can hardly be verified. See Casey (2006).
[17] The reference to the 'prevailing market conditions' is problematic: when different trading venues compete, and orders are skimmed away from the reference market, this, and the 'market conditions' it features, lose in terms of representativeness. See also Franchi (2003), p. 5. European Commission (2002), p. 11.
[18] Art. 29 (1) and (2) of the L2 Regulation.
[19] Art. 27 (3) of the L1 Directive.
[20] Real transparency depends upon the "*degree* to which *real-time dissemination* of information about order and trades is made publicly available": Sabatini and Tarola (2002), p. 4, emphasis added.

them is more difficult to gather and the execution conditions differ[21]. In lack of comparability, it is more difficult to control intermediaries' discretion when they choose where to route the orders[22]. This becomes particularly problematic when the firm can act as trading venue.

MiFID contains a rule, within the best execution obligation, which addresses the problem. As mentioned above (*supra* IV.3.1.), firms have to set up an execution policy listing for each class of instruments, the venues which enable to obtain the best possible result for each class of instruments on a consistent basis.

The list puts together all the venues on which the firm intends to act. With it, the intermediaries disclose and justify the options given to clients.

Thereinafter, the firm can execute the orders by choosing one of the venues listed. At the point of choice, the particular conflict of interest of internalisers arises. When more than one among the venues listed enable the execution of an order the firm has to compare them and assess the result for the client each of them ensures. Consistently with the idea that the costs paid by investors for execution are relevant for the purpose of identifying the best execution, firms shall, in this assessment, consider their own commissions and costs of executing the order (art. 44 (3) second paragraph of the L2 Directive).

In order to avoid that firms inflate the costs of execution otherwise than in-house to determine a relative advantage to internalisation, art. 44 (4) of the L2 prohibits firms to structure or charge their commissions in such a way as to unfairly discriminate between execution venues[23]. On this basis CESR has made clear that, for example, "a firm may not direct all its orders to another firm within its corporate group on the basis that it charges its clients a higher fee for access to other venues that is unwarranted by higher access costs"[24].

The European regulator was probably not completely satisfied with the safeguards provided for by this rule, and has therefore devised two mechanisms to restrict internalisation. First, art. 21 (3) of the L1 Directive all clients should always give their prior consent to execution performed outside a regulated market or an MTF[25]; second, art. 44 of the L2 Directive specifies that, where it comes to retail clients, to assess best execution priority should be given to the total consideration, representing the price of the financial instrument and the costs related to the execution, which shall include all the expenses incurred by the client. The focus on price is likely to give a competitive advantage to incumbent trading venues, and in particular regulated markets "which have the greatest pools of liquidity and generally offer narrower spreads"[26].

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[21] In addition to this, if the creation of alternative venues skims some orders away from the central market, the price which is formed thereon loses representativeness. Macey, O'Hara (1997), p. 219

[22] Sabatini, Tarola, (2002) pp. 11, 20. Alemanni, Lusignani, Onado (2006), p. 202.

[23] In CESR's words, "a firm may not charge a different commission (or spread) for execution on different venues unless the difference reflects a difference in the cost to the firm": CESR (2007a), p. 9.

[24] CESR (2007a), p. 9.

[25] Following Ferrarini (2007), p. 409, this "protect[s] the incumbent exchanges by alerting clients against the risks of off-exchange transactions"

[26] Ferrarini (2007), p. 407. As the author notices, on the one hand, such narrow definition of best execution is "an easy test to apply for retail clients wishing to monitor the quality of order execution" (p. 409), and a broader definition of best execution would make enforcement more difficult (p. 407).

### V.2. Portfolio management.

In the provision of the service of portfolio management, firms receive resources from the client with the mandate of managing them to obtain their best use. It is a service allowing for a high degree of discretion for the benefit of the intermediary and, hence, a high risk of clients' exploitation. Intuitively, firms can use the portfolio under management to discharge their unprofitable investments[27], to place newly issued securities of an issuer which is client to the same intermediary or securities issued by another group company or, simply, to perform an exorbitant number of transactions which are not justifiable in terms of return they allow for.

MiFID duly provided for specific rules to address these threats, beside those mandating intermediaries to only act on clients' portfolios if their actions fulfil the suitability test (see *supra*). For this service, recital 57 of the L2 Directive adds that transactions might be unsuitable if they would result in unsuitable portfolios.

Other rules specifically address the discretion accorded to managers: in particular, they aim at the *ex ante* limitation of discretion and the *ex post* control on how discretion has been deployed.

Following recital 51 of the L2 Directive, clients should be provided with information on the types of instruments which may be included, and the types of transactions which may be carried out thereon. In this respect, art. 30 (3) lett. d) of the L2 Directive also requires to make clear any limits to the transactions which might be undertaken.

Art. 30 (3) of the L2 Directive lists additional information clients should be provided with in good time, before the commencement of the business: the method and frequency of evaluation of the instruments in the portfolio, the possibility that management powers could be delegated; the benchmark against which the performance of the portfolio will be evaluated[28]; the objectives and the level of risk of the management, as well as and the limits to the discretion. This provision of information should limit *ex ante* intermediaries' discretion, since firms should ensure that their activities do not contradict what declared at this stage.

By default, some instruments and transactions can not be included in (or undertaken for) the portfolio. For example, clients are to decide whether they allow firms to: act on instruments which are more complex or more difficult to realise, such as financial instruments not admitted to trading on a regulated market, in derivatives, or in illiquid or highly volatile instruments; or perform activities which entail particular financial exposure on the client, for example short sales, purchases with borrowed funds, securities financing transactions, any transactions involving margin payments, deposit of collateral or foreign exchange risk[29].

In order to avoid that clients' decision can be induced by intermediaries willing to act in a self-serving way, recital 60 of the L2 Directive considers investment advice all recommendations, requests and advices given, "by a portfolio manager to a client to the effect that the client should give or alter a mandate to the portfolio manager". As a consequence, the rules on suitability apply.

[27] Lang (2001), p. 530. Nevertheless, other scholars argue that intermediaries are more likely to act on the market to achieve this aim, than through the provision of investment services: Hopt (1975), p. 124.

[28] Pursuant art. 30 (2) of the L2 Directive firms should establish methods of evaluation and comparison of the portfolio beforehand, i.e. benchmarks which are reasonable in the light of the investor's objectives, so that performance can be assessed against them.

[29] Pursuant recital 51 of the L2 Directive, a separate statement should indicate these circumstances.

Reporting obligations, being a means for *ex post* control of managements' behaviour, are also made more stringent for this service. Art. 41 of the L2 Directive requires firms to provide clients with a periodic statement – once every six months, as a general rule[30] – in a durable medium describing the activities carried out on the funds under management. It should contain information about the instruments included and the value of the portfolio, the total amount of fees and charges itemising the total management fees and the total costs, a comparison of the performance with the benchmark (if any).

Information about the type of order, the venues deployed, the instruments and the quantity can be provided in the periodic statement or, at the client's request, on a transaction-by-transaction basis. In which case, they should be communicated promptly in a durable medium (art. 41 (4)). Lastly, art. 42 of the L2 Directive requires communication about any losses exceeding a predetermined threshold, contracted between the firm and the retail client.

The regulation of the service of portfolio management requires to set an equilibrium between leaving margin for manoeuvre to (and allowing for prompt action from the part of) the manager, and controlling exploitation. The choice of one equilibrium among those possible depends on the answer one gives to the following question: is it efficient to limit the most informed party's discretion?

MiFID answers in the positive.

First, it prohibits operations on some instruments or transactions. The consequence would be that the clients' choice supplements the firm's discretion: those operations are allowed if the investor consent to them. Nevertheless, any exchange of opinion (not only advice under the meaning of MiFID, but also requests and recommendations) between the firm and the client on the matter trigger a suitability duty. As seen above (IV.1.1.1.), there are two ways of understanding this duty: either that the firm cannot propose itself unsuitable transactions, but can accomplish them if required by the client; or that the firm cannot accomplish any unsuitable transaction, despite the explicit consent of the client. If the former were true, after the request for unsuitable investments, the firm shall issue a warning and proceed only if the choice is expressively confirmed by the client. I have already pointed out that the wording of the directive suggests that this is not the case[31]. If the latter is true, MiFID creates a purposeless mechanism: the firm cannot choose by itself in the first place, the client's consent is requested, in almost instances this consent will be given with consultation of the firm, which leaves it in the hands of the firm the choice, since it bears the duty to only provide suitable investments. But this is exactly the same result the firm shall ensure for any investment included in the portfolio.

Intermediaries' discretion is also limited through *ex post* control, ensured by the reporting obligations. But MiFID does not give investors all the tools to exercise control: surprisingly, it does not mention clients' rights to termination the contract earlier without charges[32].

Overall, it does not appear the regulation trusts the ability of clients' to protect themselves. Then, inconsistencies on important matters such as the identification of a benchmark for the management are puzzling. The identification of a benchmark seems to be mandatory under art. 30 (2), since, in the wording of this provision, States should *ensure* that firms establish one. On the contrary, both art. 30 (3) lett. c) and art. 41 (2) lett. e) mention it as a mere eventuality. Instead, the

[30] Clients should be informed that they can be provided information more often, every three months or every month, depending upon the circumstances (art. 41 (3) of the L2 Directive).

[31] *Supra*, Chapter IV.1.1.1.

[32] This was included in the Italian pre-MiFID 11522 Consob regulation of 1 July 1998.

benchmark approach is a crucial regulatory techniques, in the light of both the discretion of the manager and the information asymmetry of the clients.

Also, it is not clear why the same client should be able to bargain with the firm on the matter of losses' disclosure: while MiFID requires that all losses shall be communicated to clients *when they reach the threshold contractually agreed by the parties*, the Italian 11522 Consob regulation (art. 28) pre-determined this thresholds.

### V.3. Financial Analysts.

Strong securities markets being a prerequisite for economic growth is nowadays uncontroversial. The direct relation between strong markets and (among other things) investor's protection has also been amply discussed. In particular, it has been stressed that investors need to bridge information asymmetries, and to act in a market which is not tainted by insiders' self-dealing transactions[33].

In this conceptual setting, intermediaries – analysts included – are crucial for granting investors protection, since they give "the investing public information on the value of particular investments"[34] and provide "valuable insight to investors trying to make sense of a wide range of information. They study companies and industries, analyze raw data, and make forecast or recommendations about whether to buy, hold or sell securities"[35]. As a consequence, they should reduce the risk inherent to investment, lower the returns demanded by the market and therefore enhance its efficiency. On the other side, though, these intermediaries acquire preferential information which they could be tempted to use at their sole benefit, hence, exploiting individual investors or tainting the market with unfair practices.

Financial analysis is provided under three settings[36]: next to the independent research firms, there are analysts belonging to firms with brokerage operations and/or investment banking businesses, and analysts belonging to brokerage-only firms[37]. Although there is a clear advantage in the joint performance of different activities[38], it is also legitimate to doubt whether the action of analysts framed in investment firms can remain unbiased[39].

All analysts face conflicts of interest insofar as they own a proprietary portfolio, or have other employment/business relationships with the issuer they revise.

[33] Black (2001).
[34] Choi (2004), pp. 2,3.
[35] IOSCO (2003), p. 1.
[36] I will use the term 'analyst' to refer to "sell-side analysts', i.e. those "who typically work for brokerage firms", and not to buy-side, employed by institutional investors. See Mehran, Stulz (2006), p. 3, endnote 3.
[37] Clarke *at at.* (2004).
[38] Krigman, Shaw, Womack (2001) have shown that investment banks have often attracted business though their analysts.
[39] Several studies have demonstrated the different biases of affiliated analysts as compared to those of unaffiliated ones (Michaely, Womack (1999)). FSA (2003b), p. 10: respondents to the first FSA's Discussion Paper (n. 15 of 2002) agreed that "conflicts of interest … [are] inherent in the role of the analyst in an integrated investment bank, and that they can, and do, compromise the objectivity of investment research".

When they are framed within investment firms potential for exploitation increases. Analysts might have incentives to further the interests of the firm or of one of its clients. For example, where the firm has brokerage activities, they can issue a buy recommendation on the instruments the firm wants to sell and thereby either enhance the possibilities to sell, or allow for a sale price increase. Where the firm has underwriting activities they might issue positive analysis to satisfy (and thus retain a profitable business with) the issuer. The means for obtaining these results is clearly the release of tainted analysis. Intermediaries can drive analysts to this through the compensation structure – linking their remuneration to the profits of other departments; making them wear more than one hat. Intermediaries can also verify that analysts serve their purposes devising reporting lines from the research department to the investment banking or other departments[40].

Complete avoidance of conflicts of interest, even ensuring that analysts are fully independent from other firm's activities is a chimera. It is sufficient for them to know that the instruments object of the recommendation are issued by either the intermediary or its group, or by a firm whose IPO is underwritten by the intermediary or its group to face conflicts of interest. Such knowledge can be acquired even where the analysts do not performs trades themselves, or are not in contact with persons employees in different business areas

Another case in which analysts' conflicts of interest can lead their behaviour is that in which they issue false or misleading statements as to the financial situation to a firm being a competitor of a client of the intermediary.

This situation features several conflictual dimensions: it substantiates a contrast between the interest of the intermediary and that of its retail clients insofar as these might thereby be averted from investments which would be appropriate for them, but appear to be worse due to biased analysis. Also, it substantiates a conflict between the interest of the intermediary and that of the retail investors in general or, in other words, the retail market for that instrument, since the recommendations are not directly addressed to investor, but are generally circulated.

The first dimension of the conflict is hardly enforceable: firms can simply not suggest or offer operations on the securities of a competitor to one of its clients, so that the content of the coverage on these securities becomes irrelevant for the investment relationship with its retail client. Indeed, firms are not obliged to offer full range of services or financial instruments, and are not required to advice the client to recur to other intermediaries, if these overall offer more tailored services for that client's need. Hence, the second dimension of the conflicts comes in the foreground. Responses to it should be provided not by MiFID but by the Market Abuse Directive. Art. 1 (2) lett. c) prohibits the dissemination of information which gives, or is likely to give, misleading signals as to financial instruments, where the person knew or ought to have known that the information was false or misleading. The first case of this type came under the spotlights with the proceeding initiated by LVHM against Morgan Stanley before the Paris Commercial Court which nevertheless did not apply the market-protective rules, but those on unfair competition and comparative advertising between LVHM and its rival, client of Morgan Stanley[41].

Analysts biased recommendations contradict several interests: not only those of the firm's clients, but also those of other investors, which collectively make the whole market for an instrument. Clients rely upon recommendations in order to decide which transactions to

[40] FSA (2003b), p. 10.

[41] The decision, issued on January 12, 2004 condemned Morgan Stanley with a 30m euros payment to LVMH; it was nevertheless rehearsed by the Court of Appeal with the ruling of June 30, 2006.

undertake, and their investment decision can be guided toward instruments which are not as suitable to their needs as the recommendation would allow to infer. They also might end up investing on instruments whose price has been inflated by the market shift determined by the recommendation. Investors' perception as to the existence of a conflicts of interest may be watered down by the way in which research is disseminated: dissemination is not necessary ensured by the intermediary producing the recommendation in the first place, but could also take place under the responsibility of a member of the group to which the producer belongs[42].

Conflicts of interest of securities analysts employed by the research department of full-service investment firms such as broker-dealers and investment banks has become an issue also for retail clients since the 1990s, when their output "has become increasingly available to retail investors", whereas before it was exclusively addressed to institutional investors[43]. This phenomenon has interested the US as well as Europe: in 2003 the FSA noticed: "investment research in the UK is overwhelmingly for institutional clients who are usually able to see through headline recommendations and the potential for bias", but also recognised that "investment bank research finds its way in abbreviated or edited form, through the media and other, increasingly webbased, distribution channels, to retail investors"[44].

The problem of analysts' conflicts of interests and the potentials for investors' exploitation has long appeared in scholars' research.

As *Mehran and Stulz* put it, "there is clear evidence in the literature that firms shopping for an underwriter care about analysts associated with the investment banks that they consider, so that joint production of investment banking services and research can increase the demand for investment banking services"[45]. The reasons for such issuers' preference needs to be explained.

The empirical survey by *Krigman, Shaw and Womack*[46] concludes that the issuers' aim is that of buying influential analysts coverage. Other studies hold that these analysts are preferred by issuers because they initiate coverage faster than other firms and maintain it longer[47]. High accuracy and timelines would be offered by in-house (large) investment banks' analysts[48], mainly because they benefit from superior information deriving from other activities of the firm[49]. Nevertheless, not all studies have found a strong evidence for such hypothesis[50].

Other studies have therefore focused on the type of recommendations issued by analysts to which issuers tend to switch and by analysts affiliated with a lead underwriter. *Ellis, Michaely and O'Hara*[51] found that the new analysts tend to be more optimistic than the previous ones. Hence, all analysts would have incentive to make buy recommendations, irrespectively to whether or not this

[42] As confirmed by art. 25 (1) of the L2 Directive, which refers to the dissemination provided for by a member of the group. Boni, Womack, (2003), Malmendier, Shanthikumar (2006) have all shown that retail investors fail to adjust for the biases in the recommendations.

[43] Mehran, Stulz (2006), p. 6.

[44] FSA (2003 CP171), p. 11.

[45] Mehran, Stulz (2006), p. 15. See also O'Brien, McNichols, Lin (2005).

[46] Krigman, Shaw, Womack (2001).

[47] Mehran, Stulz (2006), p. 15. See also Sirri (2004), p. 27, who refers to Galant (1992).

[48] I.e. they are the first to issue forecasts and to revise recommendations after the firm's earning announcement date. See also Clarke (2004).

[49] See also Michaely, Womack (1999). Clarke, Khorana, Patel, and Rau (2004); Jacob, Rock, Weber (2003). Krigman, Shaw, Womack (2001), as confirmed by O'Brien, McNichols, Lin (2005).

[50] Bradley, Bradford, Ritter (2003).

[51] Still, Ellis, Michaely, O'Hara (2004).

is led by conflictual interests they face when acting within an investment bank. Nevertheless, Womack shows that lead underwriter analysts make considerably more "buy" recommendations than unaffiliated ones[52]. Again, this finding is not conclusive: only the highest-profile firms recur to large investment banks', so that the buy recommendations issued by their analyst might be grounded for them. It is intuitive then to control for the performance of those issuances, and some studies have indeed found that the long-term performance of stock recommended by a lead underwriter is worse than that of stock recommended by a nonlead underwriter[53].

All evidence in favour of the thesis that analysts are biased when they act at investment banks[54] should be discounted by other findings on: the ability of the market to discount recommendations coming from lead underwriters[55]; the fact that biased analysis do not generally help firms to get future underwriting businesses; the credibility constraint on the investment firms which aim at becoming lead underwriter[56].

Also, the existence of biased recommendations does not tell enough about the source of the bias: it might be to gain future underwriting business or to make a prior lending business safe; also, it could be the response to other analysts' economic incentives, such as potential career and fee awards[57].

In light of potential exploitative behaviours from the part of analysts, the possibility to legally mandate that they act independently from investment firms has often been suggested. There seems to be substantial agreement that such solution would bring about extensive costs and inefficiencies. "Purely independent analysts … may not provide the level of research and breadth of distribution that maximizes societal welfare" since mandatory separation of analysts from investment banks "may … result in a drop in the available financing for analysts, thereby reducing the amount of sell-side analyst research provided into the capital markets"[58]. This goes in the end to the detriment of the markets: without simultaneous and broad distribution of research, price accuracy would decrease, whereas dispersed investors would have the incentive to undertake own research in a way that ends up being duplicative and therefore wasteful for the market[59].

In light of these debated, the European regulation allows for, but extensively regulates (investment research and) financial analysts[60] acting under the roof of an intermediary. It aims at addressing all the possible sources of incentives to conflicts exploitation and extensively uses the

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52 Womack (1996); Michaely and Womack (1999) find that: 50 percent more buy recommendations come from leading underwriters. Nevertheless, Ljungqvist, Marston, Wilhelm (2003), p. 2, find "no evidence that analyst recommendation behavior favourably influenced whether banks won either debt or equity mandates", with the existence of prior relationships was proved to play a more consistent role.

53 Michaely, Womack (1999).

54 For example: Dugar, Nathan (1995).

55 Michaely, Womack (1999). For the opposite view see Lin, McNichols (1998): the market reacts at the same way in front of the two type (lead and nonlead underwriter) of recommendations.

56 Ljungqvist, Marston, Wilhelm (2003). The authors also name, as an exception, that some intermediaries – having anyway little chance of being selected as lead underwriters – might be willing to use aggressive recommendations to obtain some chances.

57 Ljungqvist, Marston, Wilhelm (2003) argue that these latter exercise a stronger pressure on analysts' behaviour than other considerations.

58 Choi (2004), pp. 6-7.

59 Choi (2004), p. 6.

60 The persons producing investment research, pursuant art. 2 n. 4 of the L2 Directive.

regulatory technique of explicit prohibitions. To appreciate the full breadth of protection accorded to clients, MiFID should be read in conjunction with MAD and its implementing regulations[61].

The scope of MiFID's rules is set by art. 24 of the L2 Directive defines investment research as "research or other information recommending or suggesting an investment strategy, explicitly or implicitly, concerning one or several financial instruments or the issuers of financial instruments, including any opinion as to the present or future value or price of such instruments". This research shall be "intended for distribution channels or for the public" and "labelled or described as investment research or in similar terms, or otherwise presented as an objective or independent explanation of the matters contained in the recommendation". Finally, it does not have to fall under the definition of investment advice, this implying that it should not be a personal recommendation to a client in respect to one or more transactions relating to financial instruments. If these requirements are fulfilled, investment research falls under the category of ancillary services. Also, it falls under the wider category of 'recommendations' of MAD and its implementing directive (see art. 1 (3) and (4) of Directive n. 125 and recital 28 of the L2 Directive).

MiFID generally states that all information dispersed to clients should be fair, clear and not misleading (art. 19 (2) of the L1 Directive). Where this considered not explicitly devoted to analysts' reports, arts 3 and 4 of Directive 125/2003/EC openly confirms the same principle for recommendations.

L1 and L2 Directive face the problem of analysts' conflicts of interest with a number of rules which might be grouped around two main pillars: internal arrangements and disclosure. They have a common aim, namely ensuring that analysts can release objective investment research.

Internal arrangements touch upon organisation, inducements, remuneration, analyst-issuer relationship. It is legitimate to think that the concrete measures to which these arrangements give rise should be disclosed in the firm's conflicts of interest policy of art. 22 of the L2 Directive. Indeed, art. 6 (2) of the Directive n. 125 requires firms to disclose "in general terms, of the effective organisational and administrative arrangements set up within the investment firm or the credit institution for the prevention and avoidance of conflicts of interest with respect to recommendations, including information barriers".

Where a firm produces and disseminates investment research, art. 25 of the L2 Directive imposes compliance with what are named 'additional organisational requirements'. The first paragraph of this article does not add anything beyond the rules which are generally applicable, since it only states that firms should ensure compliance with art. 22 (3): procedures should be in place to ensure that analysts, as any other employee, carry out their tasks with the necessary level of independence, especially with respect to other relevant persons engaged in different business activities.

As for other activities, under art. 25 internal procedures should allow for prevention or control of information exchanges and ensure: separate supervision; that remuneration structures do not hinder the proper performance of the activities; that no person can exercise inappropriate influence on the employees' behaviour; that simultaneous or sequential involvement of employees in different activities is allowed only insofar as it does not impair the proper management of conflicts of interests.

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[61] Directive of 22 December 2003 implementing Directive 6/2003/EC (Market Abuse Directive), published in O.J.E.U. L 339/73 of 24 December 2003:

Nevertheless, recitals 29, 30 and 36 of the L2 Directive translate these principles into express requirements and prohibitions. In particular, analysts should be independent from "persons whose responsibilities or business interests may reasonably be considered to conflict with the interests of … [those] to whom the investment research is disseminated" (recital 29): "corporate finance personnel and persons involved in sales and trading of behalf of clients or the firm" (recital 30). As a difference to the rules which in general require all employees to carry out their tasks at an appropriate level of independence, this provision explicitly identifies which entrenches trigger unlawful biases.

Needless to say, analysts are also explicitly prohibited from participating themselves to corporate financial businesses and underwriting, "pitches" for new business and "road shows" for new issues of financial instruments, or be otherwise involved in the preparation of issuer marketing (recital 36).

This is coherent with scholars' findings: analysts' activity should be separated from brokerage activities, corporate financing activities, and proprietary trading, since these overlaps are mostly likely to give rise to conflicts of interest[62].

Art. 25 also contains provisions about personal transactions. This provision mirrors the general one of art. 12 of the level-2 Directive but, as a difference with this latter, it constrains firm's discretion in assessing whether the transaction conflicts or is likely to conflicts with an obligation under MiFID.

Firms shall have in place arrangements designed to ensure that analysts do not undertake either personal transactions or transactions on behalf of any other person, including the investment firm, in financial instruments to which the analysis relates, or in related financial instruments[63] with knowledge of the likely timing or content of the analysis, which is not publicly available *or available to clients* or can readily be inferred from disclosed information and the recipients of the research have had a reasonable opportunity to act on it. Exceptions to this prohibition arise: for the transactions undertaken as market markets acting in good faith; in execution of an unsolicited client order (art. 25 (2) lett. a) of the L2 Directive).

To fully appreciate the breadth of the provision allowing for transactions under the condition that the research's content is publicly available *or available to clients*, one should nevertheless read MiFID in conjunction with the Market Abuse Directive[64]. Before reaching the market, the content of the research fulfils the description of inside information: art. 1 (1) it is information of a precise nature and not made public, relating directly to issuers or financial instruments which, if made public, would have a significant effect on the prices of those instruments. Analysts can well fall under the category of insiders: persons having access to inside information through the exercise of his employment or profession (art. 2 (1), lett. c)). Before the information is disclosed, which should be interpreted as general disclosure to the market, insiders are not allowed to use this information by acquiring or disposing for own account or for the

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[62] Boni, Womack (2002), p. 104.

[63] A related financial instruments is an instrument whose "price … is closely affected by price movements of another financial instrument which is the subject of investment research, and includes a derivative on that other financial instrument": art. 25 (2), second subparagraph. It was noticed (and criticised) that the definition of related financial instruments does not cover trades in instruments of an issuer belonging to the same industry or business as the issuer object of the analysis: FSA (2003b), Annex 7, p. 8, in particular in the proposal for COB 7.13.7 E.

[64] Directive 2003/6/EC of 28 January 2003, published in O.J.E.U. L 96 of 12 April 2003 (hereinafter: MAD).

account of a third party, directly or indirectly, of financial instruments to which that information relates (art. 2 (1)). When the information is available to clients only, the concept of 'disclosure' required by MAD so that the information is not considered inside information is clearly not fulfilled. Hence, although MiFID allows to undertake personal transaction in this case, analysts should nevertheless be prohibited to do so by the firm in compliance with the market abuse prohibitions.

Art. 25 (2) lett. b) of the L2 Directive further states: "in circumstance not covered by point (a)", analysts and other persons involved in the recommendation are not allowed to carry on personal transactions contrary to concurrent recommendations, safe for exceptional circumstance and with prior approval by a member of the firm's legal or compliance function[65]. This derogation has been introduced to give account to the fact that "sales from personal accounts can be consistent with legitimate portfolio rebalancing needs or liquidity shocks".

Reading the two provisions of lett. a) and b) one can conclude that before disclosure no personal transaction can be undertaken, whereas after disclosure those coherent with the content of the research can be undertaken without limitations, and those contrary to the analysis can only be undertaken if allowed in light of special circumstances. Pursuant recital 31 of the L2 Directive , these circumstances shall pertain to the analyst's financial hardship, they only justify the *liquidation* of a position, and the approval must be obtained in written.

It is not clear whether the wording of art. 25 (2) lett. b) allows firms to exclude all waiver even where there would be the case for an exception based on 'exceptional circumstances'. It reads: Member States shall require … firms to have in place arrangements designed to ensure … that … financial analysts must not undertake personal transactions … except in exceptional circumstance. I would argue for the negative, with the consequence that, as it was under the FSA's pre-MiFID rules (COB 7.13.10A G)[66], in application of the principle of firms' self-determination of the tools for attaining the statutory aims, States can allow firms to adopt more stringent rules, always prohibiting for example analysts from carrying out all transaction.

Art. 25 contains inducement provisions which clarify that when it comes to investment research, financial analysts, other relevant persons involved in the production thereof, but also investment firms themselves "must not accept inducements from those with a material interest in the subject-matter of the investment research" (para 2, lett. c)). Here again, the regulatory technique is such that the prohibited situation is pre-determined by the law, as a difference with the general inducement rules of art. 26, which leave more margin for manoeuvre to firms. Inducements' provisions are nevertheless loosened up by recital 32 of the L2 Directive, following which "small gifts or hospitality below a level specified in the firm's conflicts of interest policy and mentioned in the summary description of that policy that is made available to clients should not be considered as inducements".

All the tools described above, also deployed for the provision of other services, are only partly sufficient to address analysts' biases. Following art. 25 para 2, lett. d) and e) firms, analysts and other relevant persons must also not promise issuers favourable research coverage, and third persons, included the issuer, are also not allowed to review draft of the investment research[67] for

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[65] Mehran, Stulz (2006), p. 7.

[66] See FSA (2003c), Annex 1, p. 8.

[67] Securities Industries Association (2001), and SEC 2002 rules: an analyst should not submit research to investment banking or to corporate managements for approval, neither report to investment banking. The FSA (2003c), p. 25 and FSA (2003b), pp. 17, stress the need for prohibiting editorial control from the part of

any purpose other than verifying compliance with the firm's legal obligations, if the draft includes a recommendation or a target price. The regulation lacks applicative details which could usefully guide intermediaries in ensuring that firms do not exercise control over analysis[68].

The current European regime heavily upon previous national and supranational rules.

It has been heavily influenced by the evolution of the UK's regulation: in 2003 the FSA issued a first consultation paper[69] which could be interpreted as mandating the separation of analysts from the sale and trading divisions. Since respondents pointed out that this could amount to the authority imposing a particular business model, the FSA[70] finally replaced "the reference to … sale and trading divisions by a reference to an individual whose other responsibilities might reasonably be considered to conflict with the interests of the clients". Similarly, recital 36 of the L2 Directive considers "ordinarily inconsistent" with the maintenance of the analysts' objectivity their participation to investment banking activities, such as corporate finance businesses and underwriting, to pitches for new businesses and to road shows for new issues[71].

In some instances, the UK measures were nevertheless less restrictive: for example, they always allowed to waive analysts' dealing restrictions on the basis of a firm's permission in writing[72].

On the contrary, the prohibition to deal before research is disclosed and their recipients have a sufficient opportunity to act on it translates, but in a less stringent manner, IOSCO's provision mandating a holding period for analysts prior to and after issuance of a report[73]. IOSCO also paved the way for the provision allowing after-disclosure personal transactions, under the condition that such transactions are not against the recommendation[74].

Quite surprisingly, MiFID does not feature more detail on two sets of rules: remuneration and analyst-issuer relationship[75].

For remuneration, it does not go beyond the rules generally devised for all firms' relevant persons. This is surprising for at least three reasons. First, art. 22 of the L2 Directive is indeed able to confront the problem of remuneration as a source of biases: it mandates the removal of links

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the firm or any third party; emphasis that beforehand transmission of the report should aim at fact-checking; require that the sample of the recommendation circulated to the issuer would not include the proposed recommendation or the price target.

68 To the contrary, the pre-MiFID English debate focused on the possibility to: oblige firms to delete sensitive information contained in the analysis (such as the proposed rating, recommendation and price target) to be transmitted to the issuer; require firms who significantly change the content or the timing of publication of the analysis after this has been viewed by the issuer to take a record of the decision and of the reasons for it: FSA (2003b), Annex 7, p. 11.

69 FSA (2003b).

70 FSA (2003c), p. 23,

71 In its first position on the matter, the FSA had expressed the view that analysts' participation to pitches and road shows should be prohibited *tout court*, whereas in its final paper it ended up openly defining them "not ordinarily appropriate": FSA (2003b), p. 17 and FSA (2003c), p. 24.

72 FSA's Handbook COB 7.13.7 E, as in force until 31 October 2007.

73 IOSCO (2007c).

74 IOSCO (2003) Core Measures under Principle I pertaining to "Analyst Trading and Financial Interests".

75 Also, one should recur to MAD and its implementing measures to find a provision which addresses the control Authorities can exercise on the recommendations disclosed: art. 3 (3) of Directive n. 125 requires that relevant persons should be able to substantiate their recommendations as reasonable, shall a competent national Authority require it.

between the remuneration of person engaged in one activity and the remuneration of, or the revenues generated by, another person in another activity where a conflicts of interest may arise in relation to those activities. Nevertheless, it is not clear why, on such sensitive matter, the regulator has abandoned the more restrictive approach it elsewhere uses for analysts, based on the identification of express prohibitions.

Second, linkages between the remuneration of analysts and those of persons acting in different firms' arms – such as the brokerage one – create strong incentives to give biased recommendations[76]. Intuitively enough, analysts are induced to issue buy recommendations when their remuneration is linked to trading volumes[77] or the success of an IPO[78].

Third, some pre-MiFID national regulations, as the UK one, already offered some guidance as to how the remuneration could be structured. In particular, the FSA allowed it to be linked to the overall profits of the firm, safe for measures of performance[79].

Concerning analysts-issuers relationships MiFID lacks two types of prescriptions: those aimed at protecting analysts and those addressing analysts' conflicts of interest specifically arising from these relationships.

Analysts should be protected insofar as they can be under the pressure of issuers: these latter might decide to disclose relevant information for the drawing of the analysis only against insurance of a favourable coverage. If firms depend on analysts' coverage, the opposite is also true: analysts increase their revenues with more coverage. 'Blackmailing' behaviours lead to inefficient outcomes for the whole market, since they either determine biased analysis or reduce the amount of analysis which reaches the investors. Although these behaviours are difficult to control for, some previous national regulations embedded rules which, through the lever of analysts' responsibility, could help ensure that they would not 'surrender' to the issuers' pressures. For example, under the FSA rules, firms changing the proposed recommendation or its timing after receiving comments from the company was obliged to keep a record of the decision and its reasons, and to allow the Authority to verify whether this was justified by material changes of the circumstances[80].

Also, analysts' impartiality might be greatly hampered by their participation to the firm they review. On this point, IOSCO proposed two alternatives: that of requiring disclosure of the analyst's position within the firm he reviews or that of plainly prohibiting analysts to cover the issuer in which they serve as manager, director or member of the supervisory board[81]. Similarly, it required analysts (or firms employing them) "to publicly disclose if the analysts have investment positions or otherwise have financial interests in issuers that the analysts review"[82]. Directive n. 125 has taken up these recommendations with reference to disclosure duties (but not with reference to the duty to abstain): art. 5 requires relevant persons to disclose "all relationships and circumstances that may reasonably be expected to impair the objectivity of the recommendation". Specific attention is devoted to the fact that the relevant persons have a significant financial

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[76] Other Authorities and private associations have also recognised it. Following the Securities Industries Association (2001) and the SEC (2002 rules) a research analyst's pay should not be directly linked to specific investment banking transactions, sales and trading revenues, or asset management fees.

[77] Boni, Womack (2002), p. 104.

[78] White (2004), p. 4.

[79] FSA (2003b), p. 17.

[80] FSA (2003b), pp. 18.

[81] IOSCO (2003), 4, Core Measures under Principle I.

[82] IOSCO (2003), 4: under the Core Measures of Principle I "Analyst Trading and Financial Interests".

interest in one or more of the financial instruments which are the subject of the recommendation, or a significant conflict of interest with respect to an issuer to which the recommendation relates"[83].

The sources of these other conflicts are clarified by art. 6, which names the fact that: the relevant person has a major shareholding in the issuer, is market maker on its instruments, has been lead manager or co-lead manager over the previous twelve months of any offer of the issuer. Importantly, art. 6 (1) lett. e) also requires investment firms and banks to disclose whether themselves "or any related legal person is party to any other agreement with the issuer relating to the provision of investment banking services"[84]. Nevertheless, this information can only be provided in general terms, since the directive requires no confidential commercial information to be disclosed in this way. In the same vein, lett. f) requires disclosure as to the existence of agreements between the issuer and the relevant person (or a related legal person thereof) relating to the production of the recommendation[85].

The interaction between MiFID and MAD's implementing directive is to some extent unclear.

Pursuant art. 24 (2) of the L2 Directive, the only difference between recommendations falling both under MiFID and MAD, and recommendations only falling under MAD is that the latter is not labelled or described as investment research or in similar terms, or is otherwise presented as an objective explanation of the matters it contains.

All in all, the difference from the point of view of investors is negligible, unless it is legitimate to believe that, since firms have to clearly identify these recommendations as marketing communications (art. 24 (2) of the L2 Directive), investors will put less reliance on them, than they would on analysis labelled as investment research.

An argument against investors' ability to differential can also be inferred by the fact that both types of recommendations have to be presented in the same way, pursuant the rules of Directive n. 125 which, in lack of MiFID's provision, provide for high standards fro fair presentation: : as a way of example, facts shall be distinguished from interpretations, sources shall be indicated, and any doubt as to the reliability of the source should be mentioned; forecasts should be labelled as such; methodologies deployed should disclosed, and the meaning of the recommendation should be explained. Importantly, recommendations differing from previous ones on the same instrument or firm, issued during the previous twelve months should highlight such differences (arts 3 and 4).

Quite surprisingly, therefore, the level of protection required for these other types of releases is lower: Directive n. 125 does encompasses organisational requirements, which should be "set up for the prevention and avoidance of conflicts" (art. 6 (2)), but MiFID's more detailed rules on personal transactions, inducements and remuneration do not apply.

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83 When the concerned relevant person is – among others – an independent analyst, an investment firm or a credit institution they shall also disclose major shareholding with the issuer, and other significant financial interest held by the relevant person (or related legal persons) in relation to the issuer.

84 Provided that "the agreement has been in effect over the previous 12 months or has given rise during the same period to the payment of a compensation or to the promise to get a compensation paid".

85 The Directive n. 125 also requires investment firms and credit institutions who disseminate recommendations drawn by third parties to act as 'watchdogs' as to the compliance with the duties of fair presentation and disclosure of conflicts of interest (arts 8 and 9).

This the legal framework currently in place across Europe. It is interesting to compare it to that currently in place in the US, which has strongly reacted to major scandals due to analysts behaviours in the early tears of the new century.

In summer 2001, following the 2000-2001 stock market crash, intense debate and regulatory activity started in the US on the matter of analysts. In May 2002 the Self-Regulatory Organisations (SROs), NASD and NYSE agreed with the SEC some amendments to their regulation on analysts. On July 30, 2002 the Sarbanes-Oxley Act (SOA) was brought into force. It required among other things registered securities associations or national securities exchanges to adopt rules on analysts conflicts of interest, fulfilling certain standards: that the supervision and the compensatory evaluation of analysts is limited to certain officials; that broker/dealers engaged in public offers (for example as underwriter) do not release research on such securities for a certain time-lapse; that analysts disclose their conflicts. As a consequence, after the new SROs rules of May 2002, NASD, NYSE and SEC undertook another round of consultation to embed the full range of SOA's requirements. The final amendments were then adopted and approved by the SEC on July 29, 2003.

The pre-SOA amendments already contained some of the requirements currently in force on supervision and remuneration of analysts, on personal trades and on disclosure. On this matter, it required diffusion of the firm's rating track report, which would allow to verify the opinions published over time on a certain issuer and eventually compare them with its performance on the market.

The amendments triggered by the SOA aimed at further loosening up the entrenchment between investment banks and research departments, and between these latter and issuing firms. Analysts' independences is thereby pursued from all points of view.

Their content focus around six areas: communications between the investment firm and the research department, analysts' compensation, subject company's intervention on the analysts' review, quiet periods, disclosure requirements for the reports, transparency to the investors[86]. Disclosure is a regulatory technique heavily deployed, but the regulation also uses 'approval mechanisms' which bind some aspects of the analysts activities.

Analysts have to be insulated from investment banking activities, and in particular from pitches aimed at soliciting investment banking businesses. This does not amount to analysts being prohibited from screening potential investment bank clients, and advicing on which clients they esteem prepared for an IPO. Coherently, these activities can be taken into consideration when establishing analysts' remuneration, which otherwise has to be independent from investment banking activities but still can be linked to the overall revenues of the firm. The compensation of senior analysts should be reviewed and approved by a committee which reports to the board of directors and cannot include personnel from the investment banking department. The committee should evaluate the performance of the analysts comparing, among other things, the recommendations given on a certain instruments and its recorded stock price movements.

Reviews of analysis are restricted for non-research personnel and contacts between this latter and analysts has to be intermediated by legal or compliance staff. In the same vein, there should be no retaliation from investment banking members against analysts if their report adversely affect investment banking businesses.

[86] See Kadan, Madureira, Wang, Zach (2006), pp. 7 ff.

Disclosure provisions cover several areas. They relate to: the compensations received during the past 12 months from an issuer under review; the previous 12-month business relationships with it; the analysts' debt and equity investments in the issuer.

Coming to the prohibitions: legal or compliance personnel should pre-approve the transactions (undertaken by persons who supervise the research analysts and any other person having influence thereon) on securities issued by the companies covered by the research. For analysts acting for the manager or co-manager firms of initial and secondary offerings, as a consequence of the SOA, quite periods already in place were extended; they were on the contrary introduced for the first time for analysts of other companies (other than the managers and co-manager) participating to the offerings.

Before these SROs' rules actually came into force, analysts of the US marketplace 'experimented' the new approach Authorities were pursuing. On April 28, 2003, the so-called Global Settlement, was agreed between the SEC, NYSE and NASD, the New York Attorney General and ten of the US top investment firms charged for "undue influence of investment banking interests on securities research at brokerage firms"[87]. It resulted in physical separation between investment firms and research department of the companies involved and applied the other measures envisaged by the regulation (on compensation, analysts' evaluation process, disclosure). Finally, the Wall Street investment banks agreed on $1.4 billion fines and penalties for past behaviours and to fund over 5 years stock-market analysis from independent research firms.

The first studies on analysts' behaviours before and after the new regulation have shown that it achieved its aim of decreasing the likelihood of optimistic ('buy') recommendations. On the contrary, negative 'sell' recommendations have become more frequent. As a consequence, they lead to weaker price and volume responses to 'sell' recommendation, whereas the 'buy' recommendations lead to abnormal reactions[88]. The downside of the new situation is that analysts could in the long term act on this better reputation and on such reactions and, at leas for some times before the market becomes aware of this, exploit the perception of reliability issuing unjustifiable 'buy' recommendation.

The 'punitive' framework set-up by the Settlement requires that securities are also covered by an independent investment firm. This could serve some purpose if the lead banks are biased. To have "a second view" helps the recipients to understand whether the first one is biased, and what weigh it should be accorded to. But if these have superior information[89], and they do start the coverage, spreading less informed opinions in the market might taint its transparency[90].

**Conclusions.**

This Chapter has considered more in-depth the specific measures enacted by MiFID for the services which more heavily expose clients to a risk of exploitation, as identified by CESR.

[87] See SEC (2003).

[88] Kadan, Madureira, Wang, Zach (2006).

[89] See literature above in this Chapter.

[90] Bradely, Jordan, Ritter (2003), p. 14, argue the contrary: that the inaccurate information of nonlead firms can bring overall better information to the market.

The analysis of the practice of systematic internalisation has allowed to conclude that, overall, MiFID duly considers the problem that firms exploit their clients when they retain the orders for execution in-house although such venue does not deliver the best possible result.

The regulation of portfolio management highly relies on the techniques of *ex ante* limitation of discretion and *ex post* control over how the discretion has been employed. If one agrees with the fact that when the risk of exploitation is high, the benefits of limiting the discretion of the most informed party outweigh the drawbacks, both techniques shall be welcomed. This being the (protective) approach of the regulator, it is unclear why other protective measures lack or are ambiguous. No provisions empower investors to take actions after they are informed about the management activities, in case they should be dissatisfied; the definition of a benchmark against which the performance of the portfolio can be assessed is not clearly made mandatory. In some cases, the regulation also relies on investors' self-help, which is contradictory with the other paternalistic rules.

The regulation of analysts is highly detailed. The main regulatory ideas – applicable to all other services – are translated into strict prohibitions. I have highlighted that other provisions could have usefully been introduced, especially on the matter of remuneration and analyst-issuer relationship. I have shown some examples describing the current US regime.

# Chapter VI

## Prevalence of the costs over the benefits of the regulation. Solutions at disposal.

As the previous Chapters have shown, MiFID's default system applicable to retail businesses is fairly proceduralised, detailed and paternalistic. All these features can entail costs which are not off-set by their benefits, and the aim of this Chapter is that of assessing the solutions at disposal against this.

### VI.1. Costs and benefits of a detailed and procedualised regulation.

Proceduralisation, despite facilitating compliance for firms and establishing a benchmark which can be easily verified by parties[1], risks being source of high costs. In fact, it can be a fertile ground for opportunisms. If agents can disguise a substantial breach and escape responsibility on the sole basis of having formally complied with the regulation, the aim of concretely protect their counterparties is frustrated.

If parties can appeal to mere formal defectiveness of counterparties' behaviours (despite their substantial compliance to the regulation) to put contracts at stake, the smooth accomplishment of business transactions is hampered.

In the context of investment services the opportunistic agent could be intermediary, arguing that it could not refine its previous assessment of suitability for not having formally received updated information about the client's profile, despite there being clear signs that the client's situation has changed. Or it could be the investor voiding investments on merely formalistic grounds any time she esteems that adverse market conditions have impacted on its profitability. This could be an easy way to shift on the intermediary the risk she is required to bear[2].

Opportunism entails a loss to individual parties – which does not impact on the overall wealth since it creates redistributive effects – as well as an overall wealth loss. Any time one party attaches a value to proper performance of the other party's obligation, and additional benefits accrue to this latter when it does not deliver proper performance, and a redistributive effect arises. The fact that the original beneficiaries of the rent are deprived thereof increases the costs of

[1] Perrone (2007), pp. 62-63, argues that procedures can be a means to protect unsophisticated clients, affected by cognitive biases.
[2] Sartori (2008), p. 15.

exchanges, since it obliges parties to invest against opportunism, giving rise to wealth reduction effects[3].

An highly detailed regulation has the benefit of making clarity as to the reciprocal rights and duties of contractual parties, and facilitates the adjudication of cases.

The tightening of the provisions appears to be a normal development of any regulation. In their study of the level of specificity of the law, *Fon* and *Parisi*[4] show that it (should) increase(s) when the area of law becomes more established, or the volume of litigation augments[5].

Nevertheless, *Fon* and *Parisi* also highlight other variables which should be considered when choosing between standards (flexible provisions) and rules (detailed obligations) to maximise the value of the law. The rate of obsolescence of a regulation[6], the complexity of the legal environment and the cost of coordination of the new rules with the previous ones are factors enhance the costs of rules[7].

One should also not neglect the importance of enforcement and the correlation between a rule-based approach and the rate of enforcement. This is a bidirectional correlation: on the one side, a credible enforcement is necessary to ensure compliance since it gives the incentives to internalise the negative externalities of an activity in a way which the regulator has deemed necessary and sufficient; on the other side, a detailed regulation (which spells out rights to individual parties) eases the bringing about of enforcement by parties. Therefore, despite enhancing the fixed costs of rule-making, they can abate the variable costs (also in terms of the time needed to seek redress) of adjudication, rules contribute to the maximisation of the law's value[8].

If one applies these considerations to the specific field of investment services it is easy to conclude for the high costs of a detailed regulation. True is that clients are – as uninformed principals – are not aware as to the behaviour they can expect from their agents: since rules provide them with guidelines on this, they and smoothen the path to adjudication. Nevertheless, financial markets are a constantly evolving field, in which the rate of obsolescence of any regulation is extremely high, the types and nature of risks constantly evolve and different aims confront each others: that of protecting investors, that of fostering business activities, that of preventing systemic risks.

If one adds to the picture the highly asymmetrical position of intermediaries and clients, these evolutions (and in particular the fact that business practices are allowed to flourish and evolve) modify the scope for information asymmetries, and give rise to new motives and opportunities for clients' exploitation. Thus, *ex ante* standardising a conflict free approach becomes prohibitive[9], contracts are increasingly incomplete, also due to the strategic behaviour of the most informed party[10].

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[3] Muris (1981), p. 525.

[4] Fon, Parisi (2007).

[5] Details of rules and rate of litigation can also be correlated the other way round:

[6] They mention, p. 21, the case of the industrial revolution, which has rendered the adoption of standards more desirable in the field of tort law.

[7] Fon, Parisi (2007), pp. 6 ff.

[8] Fon, Parisi (2007), who nevertheless also admit, p. 17, that specific rules are not always cheaper to adjudicate, since they trigger the cost of navigating though a complex web of legal requirements.

[9] Xu, Pistor (2002), p. 33.

[10] See *supra*, Chapter I.4.3.

The application of the general clauses can off-set these risks. General clause, such as those of professionalism, honesty, fairness are applied in all jurisdictions to control the conduct of agents in all contractual relationships, included the principal-agent set-up typical of the provision of investment services[11].

While the requirement of professionalism refers to the fact that clients can be damaged because the firm does not apply the specific competences – skill and care – which its role would trigger, those of honestly and fairness appear directly interlinked with the matter of conflicts of interest.

It is difficult to draw a line between these concepts. Broadly speaking, under the duty of honesty firms cannot befool the client as to the fact that a certain instruments or service fulfil their best interest, conceal information, detour clients' resources and a number of other opportunistic behaviours. Under the duty of fairness, the concept of discrimination more openly comes into play. Fair treatment means a treatment which does not unduly discriminate among clients and, consequently, does not unduly give preference to the interest of one above the other.

### *VI.1.1. General Clauses.*

Beside the cases in which the application of the general clauses has been opposed on the assumption that individuals are fully rational and their initial allocation of risks should be maintained, the main objections presented against these rules is that they render unpredictable the outcome of the economic relations[12].

The benefits of general clauses have been widely recognised. They supplement the regulatory voids due to either defective formulations of the rules, or to the fact that the rules have been 'superseded' by the business practices. For example, in contractual law they bring collateral obligations which define how and when a rule is complied with[13]. They are needed in order to avoid that a rule can be circumvented merely because it does not specify how it should be applied under specific contingencies[14].

They complete contracts[15] allowing to give relevance to circumstances which, in the first drafting of the contractual agreement where not predictable, and only arise later on when relationships (last and) evolve over time[16]; they strengthen the control over opportunism when the reputational losses can not control the incentives of the parties[17].

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[11] In the US this principles were embedded in the 'shingle doctrine'. Pacces (2000), p. 487: "In hanging out its "shingle," the financial intermediary represents to its (actual and prospective) customers that they are dealing with a professional securities expert, who has both the information and the skills they are lacking". It follows from the theory that a financial intermediary is under the duty not to take advantage of its customers. "Individual investor's reliance on financial intermediaries is actually based upon the belief that they will receive professional advice and fair treatment by securities experts".

[12] Posner (1998), pp. 44 ff.

[13] Rodotà (2004), p. 238, Di Majo (1994), p. 293.

[14] Both functions are stressed by Cossu (2004), p. 613.

[15] Bellantuono (2000), p. 337, who finds similarities with the normative default rules. Burton (1984), p. 16.

[16] Breccia (1991), p. 372. Hesselink (1998), p. 297.

[17] Bellantuono (2000), p. 352.

The general clause of honesty (or good faith) might well address the problem of strategic incompleteness[18]. As an example of this type of incompleteness one can mention the case in which the agent does not bound itself to inform its principal when losses to this latter's interest arise. The agent knows this contingency is likely to occur, but does not specify it, and does not bargain on the respective rights and obligation in order not to inform its principal about its likelihood. Conversely, under the principle of good faith, the agent can be bound to inform its principal, despite there having been no explicit bargaining on this point.

The ISD almost exclusively regulated firms' conduct of business through clauses of this type: art. 11 required due skill, care and diligence, as well as an honest and fair behaviour in the best interest of clients. It was on Member States to identify and apply specific conduct of business rules which would implement such principles[19].

The differences in national conduct of business rules arising from this where one of the main reasons why the 1993 Directive left commentators unsatisfied. The minimum harmonisation approach allowed for as many regulatory regimes as the number of Member States, and it was commonly held that this could heavily hamper cross-border provision of services. The Commission's resolution on the replacement of the ISD emphasised the insufficiency of the general clauses-based regulation[20].

### *VI.1.2. MiFID: need and scope for application of general clauses.*

As a reaction to the ISD, and as seen through Chapters IV and V, MiFID embeds highly proceduralised and detailed conduct of business rules which risk either putting the clients' interests at stake, or being further interpreted in light of financial markets' evolution.

For example, *Enriques* mentions the cases in which some of the organisational requirements – namely Chinese Walls – have not served their purpose of preventing a leak of information[21]: intermediaries shall not escape responsibility for having formally set up if the firm's employees act on – or ignore – the information they actually dispose of at the expenses of the clients.

*Kruithof* emphasises the exclusively procedural (as opposed to substantial) protection offered by the best execution rule[22]; but on this point the underlying policy is hard to reconcile with the idea of according protection of each individual client in each individual transaction. While the rationale of the organisational requirements is to anticipate the protection of individual clients to the time where the firm is set-up, but the insufficiency of organisation does not exempt intermediaries from the prohibition of clients' exploitation, the rationale of the best execution rule seems different. Firms are accorded the possibility to pre-determine their policy and to execute clients' orders in accordance to such policy. This lightens the firms' costs of compliance while

[18] See Bellantuono (2000), p. 339.
[19] As minimum standards, firms had to try to "avoid conflicts of interests and, when they cannot be avoided, ensures that clients are fairly treated", seek information from the part of the client, make adequate disclosure of material information, employ effective resources and procedures for the proper performance of businesses.
[20] European Commission (2002), p. 25.
[21] Enriques (2005), p. 11.
[22] Kruithof (2005).

benefiting the market by speeding up the execution process and puts the individual clients' loss in the background.

Other examples can be usefully recalled from the previous Chapters. As seen in the discussion of *ex ante* information, the disclosure duties do not always strike a proper balance between the risk of information overload and the need for client's aware consent[23]. The regulation does not pay due attention to the fact that clients should be given the possibility to act on the information received; the timing set for disclosure can sometimes contradict the exigency that clients take an informed decision on each transaction, the evaluations which intermediaries have to conduct to assess suitability and appropriateness might be not meaningful for any given case.

Problematically, there is mixed evidence as to the fact that the European regulation allows for their application to the maximum extent possible. To hat extent the detailed conduct of business rules allow for the application of such clauses?

While considering the replacement of the ISD, the Commission has stated that "a key objective of this overhaul has been to allow the *provision of clear and legally binding guidance on the implementation of the broad principles*. To this end, the provision provides for the adoption of common conduct of business rules through comitology"[24].

This clearly states that the aforementioned conduct of business rules are to be read as a way in which the Community leads States in their understanding of the general clauses, which are nevertheless openly mentioned in the L1 Directive. Pursuant art. 19 (1) intermediaries have to act honestly, fairly and professionally and in the best interest of clients.

Art. 19 (1) of the L1 Directive specifies that the duty to act honestly, fairly and professionally imposes compliance with the duties of paras 2 to 8 of the same article, which require an information flow between the firm and its clients, burden the firm with the suitability and appropriateness tests, mandate the establishment of a record as to the rights and obligations of the firm, and entitle clients to periodical reports.

It could therefore be the case that the rights and obligations explicitly identified exhaust the content of these clauses[25].

The debate arisen thereon shows that CESR has also shared these doubts. In a 2004 consultation on the possible advice for implementing measures, it stated: "In line with the mandate, the advice sets out criteria for assessing the minimum level of information that should be obtained instead of the minimum information that should be obtained in any particular case"[26]. This testified the intention to regulate in a way which does not exhaust the applicable obligations in all possible situations.

Nevertheless, in the October 2004 Draft Advice on possible implementing measure, it held that information and other requirements for the implementation of art. 19 (1) were already dealt

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[23] Enriques (2005), p. 11, Mülbert (2006), pp. 304 ff. If investors' "will and autonomy" becomes a dogma, Sartori (2004) sees in the good faith general clause a beneficial tool against it. Visentini (2002), p. 47, criticises the role of generic information for the management of conflicts, and emphasises that of the general clauses.

[24] European Commission (2002), p. 25, emphasis added.

[25] Following Mülbert (2006), this is probably the case for the suitability rule. Kruithof (2005), holds that the rules on clients' orders execution have probably replaced the general clause of loyalty with that of equal treatment

[26] CESR (2005d), p. 26.

with by art. 19 (2)-(8), and that its advice was only required for other issues[27]. As some scholars noticed, this could bar recourse to the general clauses of art. 19 (1) on the matter of information, suitability, appropriateness[28].

The Committee has apparently gone back to its first approach with its 2005 Advice: "the requirements concerning best execution and the prompt, fair and expeditious execution of client orders in Articles 21 and 22 (1) are more specific requirements under [the] … general principle[s]. … investment firms … should *also* comply with the requirements of Articles 21 and 22, *irrespective of whether these requirements are imposed on investment firms under those Articles or under Article 19(1)*"[29]. The conclusion which could be drawn is that the detailed conduct of business rules apply together with the general clauses, and they supplement one-another.

Other provisions can confirm this. The L2 Directive identifies other (prohibited) behaviours which are deemed to constitute breach of the general clauses: art. 26 specifies that, unless some conditions are fulfilled, the firms receiving inducements is in breach of its duties to act honestly, fairly and professionally[30]. Art. 27 identifies the "conditions with which the information must comply in order to be fair". These articles apparently embed rules which conclusively identify the signs of compliance to the fairness rule.

Despite appearances, though, they (as arts 19 and 27 above) make at their turn wide reference to the concepts of fairness and require intermediaries to fulfil duties 'as it is appropriate in the circumstances'[31]. Hence, there is ample scope for the application of the general clauses.

The possibility for a wide application of the general clauses of honesty, fairness and professionalism can also be inferred by two other provisions: recital 62 of the L2 Directive does not prohibit authorities from approving the content of the intermediary/client agreement, when they do so to establish compliance with those principles. Importantly, this recital does not limit authorities' intervention to verifying compliance with some of MiFID's specific rules, but to the named clauses, and this can only be the case when these latter go beyond what required by the specific rules.

Pursuant recital 81 of the L2 Directive, art. 19 (1) fairness, honesty and professionalism rules are also breached where, in the provision of generic advice, an investment is untruthfully presented as suitable. Since the provision of investment advice does not fall under the scope of MiFID, one could argue that this specification was needed, in order to make clear that in cases other than those regulated, the general clauses remain applicable – while they are exhausted by the explicit provisions, where applicable. Clearly, MiFID needed not clarify that, beyond its scope, the usual rules apply, which is a merely redundant statement. What this recital wants to convey, instead, is the idea that the Directive shall in no way block the applicability of the general clause of fairness and honesty, which should – despite possible voids left by the substantive rules – always conform intermediaries' behaviour.

How does the Home/Host allotment of supervisory powers impacts on the application of general clauses? In other words, can the conduct of business rules as integrated through the

[27] CESR (2004b), p. 38.

[28] Mülbert (2006), p. 308.

[29] CESR (2004e), p. 70, emphasis added.

[30] Mülbert (2006), p. 308.

[31] For example, information shall be presented in a way which is *likely* to be understood, it should contain *appropriate* performance information, it must be based on *reasonable* assumptions, comparisons must be presented in a *fair* way; fees paid should be *proper* to enable the provision of services.

general clauses be applied to foreign firms by the Host Sate? I answer in the positive and argue that this does not amount to a national restriction prohibited under art. 32 (7) of the L1 Directive.

This question has been raised mainly by German scholars, who agree there being the possibility to apply the highly-developed case-law which deploys the general clauses[32], and therefore need to attentively verify whether these clauses are applicable only to nationals, or also to incoming firms.

*Mülbert*[33] holds – albeit doubtfully – that the provisions as understood under the national application of general clauses are not applicable to foreign firms, since art. 32 of the L1 Directive impedes Host States from enacting additional requirements to the cross-border provision of services. Under this solution, two outcomes would be possible: Host State could enact conduct of business rules which mirror those of MiFID (and in particular arts 19, 21, 22, 25, 27 and 28 of the L1 Directive with their L2 implementing measures)[34] and leave to courts (or authorities' interpretative acts) the application of general clauses, which could only work for national firms; or, if they want to apply the general clauses without discrimination of national firms, they should formalise them in detailed implementing measures[35]. But this standardisation would not overcome the need for application of the general clauses. In light of the fast development of financial markets, it would only shift it to a later point of time.

Generally speaking, regulators across Europe have refrained from introducing more detailed rules of conduct where the directive itself has left some space of manoeuvre for the general clauses. This is the case of Italy, Germany and the UK[36]. Under this setting, the aforementioned solution triggers the following concerns.

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[32] In the years between the ISD and MiFID this was not clear. Before the ISD, the activity of trading in securities fell under the regulation of the "commission contract" of the German Commercial Code (§§ 383 ff. HGB). Its general obligations were elaborated and clarified by both case-law and legal scholars to create a set of standard-of-business rules for the industry. Against this framework, the implementation of the ISD's general principles was simple and could easily go uncontested. Nevertheless, with the enactment of the Securities Trading Act (WpHG), scholars and courts felt that a shift in focus (from private law to statutory law) was needed. For example, since the ISD was less detailed than the pre-contractual information duty under general law, scholars and courts did not agree as to whether this possibility remained in application of the contractual law. See Mülbert (2006) p. 302. Nowadays scholars argue that cornerstone rulings such as the 'Bond' one (Bundesgerichtshof, Federal Supreme Court, 6 July 1993, XI ZR 12/93) are not outdated but simply need adaptation: Barry, Bracht, (2008), p. 1186.

[33] Mülbert (2006), pp. 318.

[34] Although it is legitimate to ask whether this is a compliant way to implement, since European directives should only identify the aims and leave member states free to devise the tools for attaining them.

[35] Admitting that implementing measures can go beyond the simple copying-out of the directive and are thereby not considered additional measures contradictory with the harmonisation required under MiFID.

[36] Italy has implemented the directive through TUF and Consob's regulation 16190. Germany has adopted the Act Implementing the Markets in Financial Instruments Directive (Finanzmarktrichtlinie-Umsetzungsgesetz – FRUG) and thereby amended the Securities Trading Act (Wertpapierhandelsgesetz – WpHG); the Federal Ministry of Finance and BaFin have issued supplemented the FRUG by means of a number detailed ordinances Ordinance Specifying Rules of Conduct and Organisation Requirements for Investment Firms (Verordnung zur Konkretisierung der Verhaltensregeln und Organisationsanforderungen für Wertpapierdienstleistungsunternehmen – WpDVerOV), and have amended the existing ones (the Financial Analysis Ordinance (Finanzanalyseverordnung – FinAV) and the Securities Trading Reporting Ordinance (Wertpapierhandel-Meldeverordnung – WpHMV)). In the UK, the FSA has amended its Handbook, in particular the COB part, currently renamed COBS.

It establishes "different level of investor protection depending on the Home country of the investment firm"[37], but also depending on the way in which the service is provided, whether with or without setting up branches. The same service provided to the same client would fall under the fairness test of the State where it is provided if performed by a national firm, and would be exempted from it if provided by a foreign branch. This would render branches' operations immune to all application of general clauses, while in case of provision of services without establishment, the firm would be subject to the general clauses as applied by their Home State. If this were true, the current allotment of supervisory competences between Home and Host States[38] would result in a discrimination between organisational set-ups, and trigger an importance sacrifice of the clients' interest. On the contrary, its aim was that of ensuring the most efficient protection of clients and differentiate between set-ups only where this is necessary to ensure effective supervision[39].

In my view, the mechanism of integration through general clauses is embedded in MiFID itself, so that a State which applies 'integrated' conduct of business rules cannot be seen as applying the Directive *and* additional requirements, but simply the Directive *with* its form of legal completion, which is included in art. 19 (1) of the L1 Directive and is referred to by a number of other rules.

From this perspective, in lack of a uniform, supranational application of the general clauses, the European regulator has accepted that national jurisdictions supply. In fact, art. 32 (7) leaves it with the Host Member State the implementation of the conducts of business rules, included art. 19 which contains the general clauses.

As it was under the ISD, the coexistence between specific rules and general clauses appears to continue[40]. Nevertheless, toady, this circumstance contradicts a clear aim of the Directive, namely that of ensuring a Europe-wide levelled paying field through the mechanism of maximum harmonisation[41]. Non only the national understanding of general clauses, but also the ways in which they can be 'managed'[42] vary across Europe.

Nevertheless, two trends should be highlighted. First, Member States are increasingly putting the management of the general clauses in the hands of the public regulators; second, and because of this, there are the preconditions for the interpretation of the general clauses across States to converge Let us analyse the first point.

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37 As recognised by Mülbert (2006), pp. 319.

38 Whereby conduct of business rules are under the competence of the Home State when the firm provides services cross-border under the free provision of services, and branches are instead supervised by the Host State.

39 In addition to this, if the integrated rules made by national authorities were only applicable to national firms (and not to cross-border businesses), one of the benefits of disentangling regulation-making and national borders would be lost, namely that of avoiding the capture of the regulator by local lobbying (see *supra* I.4.).

40 As a difference to the ISD, the current regime is the result of detailed supranational obligations which, in certain areas and for certain situations, clarify what should be deemed to be a fair behaviour, and the national understanding of the general clauses.

41 Enriques, (2005), p. 3: "It will be impossible to ensure uniform EU-wide interpretation of such a fuzzy concept as 'fairness'". Enriques, Gatti (2006), p. 952 who argue that open-ended standards can only lead to uniformity as long as enforcement is centralized.

42 They can be applied by supervisory authorities or by courts; they can be the result of the application of fiduciary duties of contract law, or of the regulation itself.

In Italy, before MiFID, the regulation on the provision of investment services already contained both general clauses and detailed conduct of business rules[43].

Following this, the general clauses of contract law were interpreted as applicable in a way which is specific to the peculiarities of the relationship between intermediaries and clients, for which the conduct of business rules identify a mandatory starting point and the main policy objectives. Consob has administrated its regulation translating such principles in the specific field[44] through its soft law instruments ("*Massime e Orientamenti*", i.e. positions taken on requests). The judges have made reference to the interpretative positions expressed by the authority[45], but have also admitted the possibility to go beyond them[46]. Perfect convergence of the two was nevertheless not granted.

After MiFID, Consob has started issuing the Level 3 provisions which MiFID envisages in recital 12 of the L2 Directive: to avoid that the regulatory regime could entail too much uncertainty, authorities are required to issue (non-binding) interpretative guidance clarifying the practical application of the provisions.

The first consultation paper issued by the Italian authority on the matter of the distribution of illiquid financial products is an example thereof. It covers a number of aspects of transparency and information, as well as others on the proper evaluation of suitability and appropriateness[47].

It also has its legal source in art. 31 (2) of the L2 Directive, following which "Member States may specify the precise terms, or the contents, of the description of risks required" under the same article. Nevertheless, the document contains a number of provisions which are a mere interpretation of the general clause of fairness, as also made clear by its heading "intermediary's duties of fairness and transparency when distributing illiquid financial products". This clearly hints to the fact that the content of the general clauses will increasingly, and in a more comprehensive way, left to the appreciation of the public authority – under the aegis of recital 12 above.

The other Level 3 document issued by Consob[48] leads to the same conclusion: it contains interpretations as to the provision of soft commissions (under the form of investment research)

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[43] Alpa/Capriglione –Alpa, 219 and others referred to by Miola (2002), p. 161 stressed the importance of including them in the sectoral regulation, in order to reinforce their applicability. Some Italian scholars have criticised (as confusing or redundant) this regulatory technique: Rabitti Bedogni (1999), p. 95, Annunziata, p. 278, Cera (1994), p. 32, Castronovo (1993), p. 313.

[44] For example, Consob (statement n. 97006042/1997) stated that the duty to inform clients about conflicts of interest should not stretch out to all cases in which the intermediary placed instruments of an issuer having a lending relationship with the same intermediary or another company of the group. In fact, in light of the features of the national market, this would have amounted to such information being always due, with the drawback that it would lose its representativeness.

[45] Tribunal of Mantua, 12 November 2004 and Tribunal of Lecce, 28 June 2004, refer to Consob's communication DI/30396 of 21 April 2000 on the matter of the information to be acquired from the client. Scholars also refer to the Authority's interpretative acts when analysing and commenting the position taken by judges on the matter of intermediaries' responsibility for misselling: Della Casa (2005) refers to DI/98087230 of 6 November 1998 on the information update, DI/98080595 of 1998 on the duty to gather more information than that identified by the regulation when necessary for the purpose of correctly assessing the appropriateness; Pisapia (2007) mentions communications 69397 of 19 September 2000, 990371285, of 11 may 1999, n. 98088209 of 11 November 1998 making special reference to the duties of the portfolio manager.

[46] Tribunal of Palermo of 16 march 2005 openly states that the fulfilment of the Consob's regulation is not a necessary but not sufficient sign of compliance.

[47] Of 26 May 2008, available at http://www.consob.it/main/regolamentazione/consultazioni/index.html.

from brokers to investment managements. As seen above, it is fairly precise, but it does sometimes appeal to vague concepts, such as coherence and reasonability[49]. Given the readiness and the authority of these interventions, as well as the technicality of the field concerned, the further interpretation of these clauses will probably increasingly be in the hands of the public supervisor.

In the UK, regulatory duties on intermediaries were enacted to avoid that the strict application of fiduciary duties hampers all operations of financial intermediaries. At least until they were elaborated by self-regulating bodies, it could be held that they were a contractual opt-out from (or a contractual way to modify the scope of) the fiduciary law. Under this framework, courts filled in the lacuna of regulatory law making application of the fiduciary standards. Indeed, this could be justified arguing that on the aspects not covered by the regulation, the parties did not contract out of such standards[50].

The entrenchment between regulatory duties and common law of care was also close. The former were enacted taking the latter into great consideration[51], but the application of the latter started being highly influenced by the former[52].

Since the Financial Services Act of 1986, the regulatory duties "have 'hardened' considerably"[53], and the apex of this process can be found with MiFID: the protection accorded to retail clients cannot be moulded with the agreement of the parties.

In asking whether and how these bodies of laws can interact, and the regulatory voids can be filled, *Chiu* admits that several options are now possible: it could become difficult for a claimant to "to convince the court of a breach in common law if there is no breach of a counterpart in regulation"[54]; the regulatory standards enacted pursuant MiFID might be flexibly applied in order to take account of situations which do not fall within the text of the law; they might be only literally applied (as a consequence of the predominant use of administrative penalties, which would only enable a strict application), leaving it to fiduciary law the task of supplementing the voids, in application not of the contractual theory[55], but of the thesis following which fiduciary standards have a core content which can never be neglected.

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[48] Of 1 August 2008, available at http://www.consob.it/main/regolamentazione/consultazioni/index.html. See above, IV.5.

[49] For example, the research offered by the broker shall be coherent to its field of expertise, and coherence shall be evaluated depending upon the level of specialisation of the broker. The criterion of reasonability applies when the manager has to value the research to take it into consideration for the drawing up of the transmission policy.

[50] See *Brandeis (Brokers) Limited v Herbert Black, American Iron and Metal Company Incorporated Lito Trade Incorporated* [2001] WL 513189. This case is nevertheless complicated by another circumstance: the regulatory obligations did not contain a void, but the void was created by the parties contracting out from some of them.

[51] Chiu (2008), p. 266.

[52] In *The Queen (on the Application of Kenneth Green) v The Financial Ombudsman Service Ltd* [2003] WL 933266, the court exceeded what was normally required under the law of negligence since it judged the exercise of care by hindsight, and not at the time of action.

[53] Chiu (2008), p. 258.

[54] Chiu (2008), p. 268.

[55] But the contractual theory can be applied if one considers that the regulatory duties are partly similar to the fiduciary duties, so the mandatory rules are a way to grant parties results allowed for under the former and the additional results deriving from the application of the latter.

Under these scenarios, the regulatory law would develop and be managed separately from the common law, with a problem of duplication or inconsistencies. *Chiu* has furthered point out that, under the FSA's new principle-based approach, the management of fiduciary standards could be usefully put in the hands of the supervisory authority[56].

The convergence of national interpretations of general clauses is facilitated by the Lamfalussy framework. As seen above, the level of concrete application of the regulation in the field of securities is left to national authorities, but both the Commission and CESR intervene to ensure uniformity of application. On this respect, on 23 January 2009 the Commission has issued a Decision[57] formalising the framework under which the Committee acts. Recital 8 entrusts it with the task of contributing to the day-to-day implementation of the legislation and recital 13 allows authorities to refer matter to it for a non-binding opinion (these powers are described in more detail in art.4). It can also share best practices (art. 4); its role in identifying the risks in the securities sector irrespectively to the traditional distinction between banking, securities and insurance sectors (art. 5 and recital 18) puts it on the footing of triggering coordinated discussions at the national level.

**VI.2. Costs and benefits of default systems. Opt-outs.**

Default rules – i.e. rules which predetermine by default the starting point of economic players – are useful to overcome biases and lack of willingness or power to undertake self-help actions, such as bargaining over rights. The most common (and studies) example of default rule is the rule establishing the automatic enrolment of employees in pension plans, which avoids the economic loss due to procrastination or omission biases[58].

MiFID's regime (conduct of business rules) for retail clients can be equalled to a default rule, in that they give investors an initial endowment of rights which they cannot bargain themselves for. But this regime is a default very complex to manage, sine it does not only identify the need for protecting weak contractual parties; it also comprehensively set the protection for many circumstances.

All defaults could easily be not cost-effective, if for example – to stick to the case of pension plans – the persons who lose from the enrolment as devised by the default are more than those who benefit from it. This and this holds more the so true for MiFID-like defaults.

It should benefit a vast and heterogeneous number of players. But the effectiveness of the default crucially depends upon the exact identification of the features of its beneficiaries (and consequently of what they exactly need), and the more beneficiaries are at stake, the least accurate the matching can be.

The application of MiFID's default also requires efforts and costs from the part of firms. To reduced them to the minimum extent possible, its should be possible – but it not always is – to determine what parties would be interested in bargaining for.

[56] Chiu (2008).

[57] Decision 2009/77/EC, published in O.J.E.U. L 25/18 of 29 January 2009.

[58] See *supra*, Chapter I.

Defaults which aim at protecting investors sometimes require to sacrifice the interest of flexible and fast business transactions. Since timeliness and flexibility is crucial for the growth of financial markets, over-application of these defaults also has social costs.

The problem of inaccurate defaults can be solved through an opting out mechanism: i.e. a mechanism which allows parties to avoid the predetermined rules and adopt individually tailored (or at least a set of less stringent) ones.

### *VI.2.1. Need and possibilities for opting-out under MiFID.*

As shown in the first Chapter, the optimal balance between a paternalistic and a libertarian has, as a precondition, the proper identification of the players' features. But on this point, MiFID appears to imply that investors are rational but uninformed and boundendly rational at the same time[59].

After the identification of the distribution between informed, uninformed, biased investors, as well as the occasions and motives for exploitation, the rules should correct the mistakes that the uninformed players would do (minimise the costs of errors) while less than proportionally increasing the possibility that rational players are hindered from taking the right decisions they could otherwise take (minimise the costs of the missed right decisions).

The paternalisms of MiFID gives some concerns on this point: in many instances, it deprives clients of the possibility of making possibly correct investment decisions[60]. Also, the class of clients to which such default applies is considerably vast. To better appreciate this, I depict the boundaries of MiFID's class of retail clients and compare it to the same class as it was under the UK and the Italian regulation before MiFID.

The UK and Italy, as all other pre-MiFID European regulations, used the tool of clients' categorisation as a way of moulding the application of conduct of business rules. Art. 11 (1) of the ISD required States to devise and apply conduct of business rules "in such a way as to take account of the professional nature of the person for whom the service is provided". By so doing, the national regulators were required to strike a balance between two needs: that of enacting rules for the protection of investors[61], and that of avoiding an overregulation which would set out constraints and entail – in the last place – costs for investment firms and clients[62].

#### *VI.2.1.1. Retail clients before MiFID: UK, Italy.*

Lacking a common rule, national regulations implemented art. 11 of the ISD grouping clients[63] around, two or three classes, and devised a treatment for each class which depended upon

[59] *Supra* III.2.1.

[60] *Supra* IV.1.1.1.

[61] Blair, Walker (2006), §§ 10.53, 10.54, pp. 397-8.

[62] This is explicitly stated in the English Financial Services and Markets Act 2000, Part. I – *The Regulator*, sec. 2 – *The Authority's general duties* (2) (c) and Part. I – *The regulatory objectives*, sec. 5. Among Italian scholars see Annunziata (2003), p. 115; Gabrielli, Lener (2004), p. 47; Alpa (2004), p. 743.

[63] The terms "clients" and "investors" are used as interchangeable terms, which identify the investment firms' counterparties in the provision of investment services. Nevertheless, the English regulation draws a

the level of sophistication of the clients it included. The correspondence between classes and level of protection was easy: the less sophisticated the clients, the more obligations firms had to comply with. Intermediaries were required to identify the class to which each client belonged, and consequently comply with all the obligations which the regulator deemed necessary to protect an investor with those features[64].

The UK featured a threefold categorisation, which included private clients, intermediate clients and market counterparties (MCPs)[65]. The FSA's Handbook stated: "[the] purpose is to ensure that clients are appropriately categorised so that regulatory protections are focused on those classes of client that need them the most, while allowing an appropriately 'light-touch' approach for inter-professional business" (COB 4.1.3 G (1)).

Under this regulation, private persons were always considered unsophisticated clients, unless they could fall under the concept of 'expert private customers', a grandfathering test which I will describe below.

Bodies corporate were considered unsophisticated: if they were not listed or admitted to trading on any EEA exchange, nor listed or admitted to trading on the primary board of any IOSCO country official exchange; if they did not have called up share capital or net assets of £ 5m[66]. These quantitative thresholds applied on a group basis[67].

The Italian regulation only made limited reference to clients' categorisations. Art. 6 (2) of the TUF required a treatment which could match the clients' different need for protection. This principle was exemplified by art. 23, which allowed Consob to waive – for clients of sufficient professionalism – the rule on the form of the contracts. Art. 30 also mentioned the category of professional clients, but left it to the Consob its definition.

Details about the categorisation were to be found in Consob's regulation n. 11522 of 1 July 1998[68], whose art. 31 identified the classes of retail and qualified investors.

Private persons were always considered unsophisticated investors, unless they featured the level of professionalism required for undertaking administration, direction or control tasks in the governance of financial intermediaries. As specified by a Treasury decree of 1998, professionalism was understood as possession of experience in administration, direction and control of companies, or in banking and financial sector's operations, gained in the course of one's employment[69].

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more detailed distinction: A client is any person receiving firms' services, included the so-called 'market counterparties', i.e. the most sophisticated clients. A customer is any client, with exception of market counterparties (FSA's Handbook, PRIN 1.2.2 G).

64 To put it in another way, "client classification is essentially a mechanical process by which each client is placed by the investment firm concerned into one … pre-determined class…": Blair, Walker (2006), § 10.54, pp. 397-8.

65 I will exclusively consider the classes of private and intermediate clients, of which MiFID's categorisation has mainly shifted the boundaries.

66 But financial services institutions, recognised investment exchanges, regulated markets, clearing houses and the like were never considered unsophisticated clients.

67 FSA (2006b) p. 7.

68 Amended by deliberation 13710 of 6 August 2002, and lastly amended by deliberation n. 15961 of 30 May 2007, hereinafter: '11522 regulation', available at www.dt.tesoro.it/Aree-Docum/Regolament/Intermedia/Compendio-/Versione-22/21.pdf.

69 Decree n. 468 of 11 November 1998, in Gazzetta Ufficiale (Official Journal) n. 7, 11 January 1999, available at http://www.dt.tesoro.it/AreeDocum/Regolament/Intermedia/Compendio-/Versione-24/06.pdf.

Bodies corporate others than authorised intermediaries, collective investment undertakings, pension funds and the like (considered qualified investors) could fall under the category of unsophisticated clients where their shares were not admitted to trading on a regulated market. As a rule, then, corporations easily fell under the lower class, safe for the grandfathering test which I will describe below.

*VI.2.1.2. Retail clients under MiFID.*

Nowadays, MiFID requires a threefold clients' categorisation: retail clients, professional clients and eligible counterparties (ECPs), and moulds conduct of business rules accordingly (recitals 31 and 41, arts 4 (1) nn. 11), 12) and 19 (10) lett. c) and 24 of the L1 Directive).

The lowest category of (retail) unsophisticated clients includes by default: all individuals and those bodies corporate who do not reach on a standalone basis at least two out of three quantitative thresholds. These thresholds refer to the balance sheet total (of 20m euros or more), net turnover (of 40m euros or more) and own funds (of 2m euros or more); thresholds are not to be evaluated in a group perspective, but on a company stand-alone perspective. No importance is given to the fact that the shares are admitted to listing.

As compared to the UK, MiFID considers more clients as unsophisticated. This is the case of bodies corporate: although before MiFID an higher amount of own funds were required for firms to be treated as professional clients (5m £ as compared to 2m euros today), this was the only requisite necessary (alternatively to the same amount of assets). Today, instead, the extent of own funds is not *per se* sufficient, and the same goes for the value of assets, since the Directive requires firms to fulfil two out of three parameters. In addition to this, the threshold have to be reached by the company on a standalone basis and not on a group basis.

Since MiFID's retail conduct of business rules grandly mirror the previous FSA regime[70], the result is that the scope of the protective default regime has been expanded by MiFID, i.e. the default rule applies in more cases.

Also as compared to Italy, the retail class is more extended, and encompasses all private customers, without exception for those who fulfil special professionalism requirements. By the same token, all bodies corporate who do not reach quantitative parameters relating to own funds, balance sheet total and net turnover are retail clients, irrespectively to whether their shares are admitted to trading on a regulated market.

In my view, giving relevance to the fact that the firm is admitted to listing – as the UK and Italy did – embeds an important consideration: since firms are guided to such admission thanks to the services of an intermediary, they are an important source of business for this latter; they consequently have superior contractual strength and a standing as 'preferred' client as compared to others. The risk that these firms' interests are postponed to those of the intermediary or of the other clients should therefore have a smaller impact. On the contrary, MiFID probably has given importance to another consideration when devising the boundaries of the professional clients'

[70] Which included The suitability rule (coupled with the obligation to gain information on the account of the investor), the best execution rule, and the rule requiring firms to provide clients with information about the financial instruments and their risks

class. Since the attitude toward listing varies grandly across Europe[71], it has endeavoured to select criteria allowing for the application of the conduct of business rules net of the idiosyncratic features of the market.

The current (quantitative) thresholds are based on considerations on objective comparability. But if one considers a few data on the composition of the European non-financial industry, such thresholds are probably too high. Pursuant Eurostat's data, by 2005 Small-Medium Enterprises represented 99,8% of all non-financial businesses in Europe[72]. Braking down the aggregate data, medium businesses accounted for the 1,1% of the total, small businesses accounted for the 6,9% and micro businesses accounted for the 91,8%.

The Commission Recommendation 2003/361/EC gives a definition of all three classes. Firms with net turnover of ≤ € 50 mil. *or* balance sheet total of ≤ € 43 mil. can be considered medium businesses, while both financial ceilings are reduced to ≤ € 10 mil. and ≤ € 2 mil. for small and micro businesses respectively. Since MiFID's minimum thresholds are only reached by firms which fall under the class of medium enterprises, only 1,2% (at most) of all non-financial enterprises in Europe can fall under MiFID's professional class. Notice that businesses only need to fulfil one of the thresholds of Recommendation 2003/361/EC to be counted in the relevant 1,1% of SMEs, while professional clients need reach both of them (or one of them, but have at least € 2 mil. of own funds). Even in lack of detailed data on how many medium businesses reach both thresholds, it is nevertheless possible to conclude that a negligible part of the European non-financial firms are accorded the treatment as professional clients.

This allows to conclude that the existence of a opt-out mechanism might be necessary to counterbalance the extensiveness of the default system. Such system does exist, and is the grandfathering mechanism following which retail clients can request treatment as professional clients. But how easy is it to deploy such mechanism? And how much opt-out is allowed for?

To answer these questions I first compare the grandfathering procedure under MiFID to those in place in the UK and Italy before MiFID. How much can be opted out depends on the differences between the retail and the professional regimes. Also in this respect, I summarise the current situation as compared to the pre-MiFID one.

### *VI.2.2. Easiness of Grandfathering: UK, Italy and MiFID.*

Under MiFID the grandfathering of retail (both individuals and corporate) customers has to be evaluated against pre-determined benchmarks and is highly proceduralised.

Grandfathering takes place upon request if these clients meet at least two of the three following quantitative and qualitative requirements: having carried out – on average and per quarter over the last four quarters – transactions of significant size on the relevant market; having a portfolio of over € 500 000; having worked for at least one year in a professional position which requires knowledge of the transactions or services envisaged. When it comes to companies, such requirements need to be fulfilled by the persons authorised to carry out transactions on behalf of the entity (Annex II.II of the L1 Directive).

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[71] For a general discussion of the topic see Demirguc-Kunt, Levine (1999).

[72] Eurostat (2008). These data, published on 8 April 2008, are the latest at disposal: they take the 27 EU countries into account.

Moreover, MiFID seems to require intermediaries to undertake an additional test before grandfathering investors: irrespectively to the fact that they meet the parameter identified (size of portfolio, number of previous transactions etc.), intermediaries also have to be satisfied that they have the experience, expertise and knowledge necessary for making own investment decisions and understand the risks involved. It is therefore difficult to assess how often the intermediaries will be willing to bear responsibility inherent to the performance of this blurry test, which adds up to the benchmark test.

All in all, the new directive seems to hinder grandfathering: this can be argued also by comparing it with the relative easiness of the downgrading procedure, by which clients automatically falling under the class of professionals are treated as retail clients: for this purpose, it is sufficient a request from the part of the client, or a decision of the firm (art. 28 (3) lett. a), b) of the L2 Directive).

Under the pre-MiFID UK regime, the grandfathering of private individual investors depended upon the fact that such investors could be considered 'expert private customer'. The mechanism appeared to be similar to that under MiFID, but the flexibility of the approach was considerably higher.

Pursuant COB 4.1.9 R it was to the firm to evaluate the opportunity for grandfathering. Taking "reasonable care", it had to assess whether the client had sufficient expertise and understanding to be included in the class of more expert investors. COB 4.1.10 G made generic reference to the client's knowledge, her previous activities, the size and nature of her transactions and her standing, without identifying thresholds as MiFID does.

The FSA used to evaluate firms' conduct on this matter in the course of its visits to authorised professional firms, and had the occasion to further give guidance on private customers' grandfathering: "a substantial net worth alone is not sufficient support for making … [a] classification [as intermediate customers of private customers], nor is ownership of a business or holding directorship"[73]. Firms had to issue a written warning to the clients as to the protection they would lose as a consequence of the grandfathering and to obtain a written consent from their part[74].

In Italy, the grandfathering of retail corporate clients was extremely easy but highly controversial. It could take place any time the company's legal representatives would state a specific experience and knowledge in the field of financial instruments' transactions, and was sufficient for all legal entities to reach the highest class.

This possibility has been widely criticised: it was not clear what was meant under the terms "specific experience and knowledge". Considering that any such statement from the part of legal representatives could shift the categorisation of all body corporate, including those not performing any activity in the financial system, the risk of abuses was particularly high[75].

Court decisions therefore stressed the importance of the intermediaries acting in good faith and in particular not giving credit to self-declarations which clearly did not match the real

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[73] FSA (2003d), p. 3.

[74] The same is required under MiFID, where this disclosure is less meaningful, since the grandfathering shall take place at the client's initiative.

[75] Chionna (2005), pp. 36 ff.; Bruno, Rozzi (2007), p. 283; Sartori (2005). Judiciary body's concerns are epitomised by the Tribunal of Milan, ruling of 3 April 2004.

situation[76]. This had to be evaluated, for example, having regard to the size of the firm in terms of balance sheet and net profits[77].

Scholars approached the problem in a similar fashion, stressing intermediaries' obligation to obtain information about the clients' profile, any statement of theirs notwithstanding[78]. They nevertheless did not agree with courts as to the circumstances which could univocally hint to an high degree of professionalism: some indeed rejected all 'quantitative' indices, holding that they would not shed any light on the real activity of the firm, which could in turn be a stronger proof of its expertise in investments[79].

It is now interesting to evaluate which regime applies to retail clients once they are grandfathered; in other words, what the default system for professional business is. This allows us to understand how much opt-out is concretely allowed under the grandfathering.

### *VI.2.3.How much opt-out?*

#### *VI.2.3.1. Conduct of Business for Professional clients: MiFID and before.*

Unlike for eligible counterparties, the L1 Directive does not contain any rule waving altogether the application of certain conduct of business rules for professional clients. Art. 19 (10) lett. c) defers to the L2 Directive the task of devising implementing measures which take into account the retail or professional nature of the clients.

The L2 Directive holds for irrelevant the status of clients with respect of the need to prevent/avoid conflicts of interest exploitation (recital 25). The information about the existence of conflicts which could not be managed through the organisational measures shall always be provided[80].

Nevertheless, recital 5 of the L2 Directive undertakes to consider the professional nature of clients for matters related to information flows between the firm and the investors. Recital 44 is even clearer on this point: "professional clients should, subject to limited exceptions, be able to identify for themselves the information that is necessary for them to make an informed decision, and to ask the investment firm to provide that information".

It is up to Member States to define the amount of information a professional client shall be accorded on the nature and risk of financial instruments, but they can be presumed to more easily

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[76] Tribunal of Milan, 21 February 1995 and Tribunal of Turin, 27 January 2000 ruled out the clause – included by the intermediary itself in the contractual agreement – stating that the client was a "qualified investor". See also Tribunal of Novara, 18 January 2007, n. 23 and Tribunal of Verona, 22 June 2007.

[77] Tribunal of Milan, 3 April 2004.

[78] As Bessone (2002), p. 69, notices, individuals should be required to actively prove, and not merely state, the ability to undertake portfolio investment decisions and to organise market activity. Sangiovanni (2007), p. 1097. Chionna (2005), pp. 36 ff.. D'Agostino, Iuliucci (2002), pp. 38 ff., frame the obligation of obtaining accurate information from the investor in the rule of diligence applicable when a person is acting in its capacity as a professional.

[79] Chionna (2005), p. 36 ff..

[80] In Chapter III, I have argued that this type of information is likely to bear significance – if any – to clients other than biased ones. It therefore makes sense to extent this duty to investors other than retail ones.

understand these features (art. 31). This discretion allows national authorities to decide whether, and to what extent information about the items listed in art. 31 (the volatility of, the additional obligations embedded in, the leverage of the instrument) shall be disclosed in light of the features of the client concerned.

While art. 36 waives the appropriateness test, art. 35 lightens the suitability one. Under this latter, the firm has to compare the features of the investment with the investment objectives of the client, her financial and economic standing, her experience and knowledge. For professional clients upon request art. 35 (2) allows intermediaries to assume that a client which has been classed as professional with reference to the investment concerned has sufficient knowledge and experience to understand the risks involved. For professional clients by default, not only the 'knowledge test' is waived, but also that on the client's financial capability. What remains is a firm's assessment as to the consistency between the investment and the objectives of the client.

The application of the suitability rule can also bear importance in the protection of sophisticated clients against exploitation, especially in light of discretion exercised with portfolio managements and investment advice. Nevertheless, for these clients the observation that investors shall be accorded the right to take decisions beyond that of the firm (and shall be accorded the possibility to act upon the information they receive or already have) holds particularly true. Nevertheless, the aspects of the suitability rule which restrict these possibilities are not waived. The light-touch approach seems therefore to be adopted more having the firm's costs of compliance in mind, than considering the proper balance between protection and investors' self-help.

In both Italy and the UK, professional businesses had an extremely light-touch approach before MiFID. The common feature of these two regulations was that firms did not have to comply with the rules mandating the provision of information on the existence of conflicts of interest and other information as to the nature, risks and consequences of the investments; needed not gather information on the account of the clients, in order to assess the appropriateness of the services.

Concerning portfolio management, in Italy firms did not have to set out in writing the characteristic of the service (types of activities allowed and underlying instruments), the ways in which the investor could give instructions, the operations which the firm was not allowed to undertake and the benchmark for the management. By so doing, the regulator enforced the view that, at least where clients are on the footing of otherwise disciplining firms' behaviours, the costs of limiting the most informed party's discretion outweigh its benefits.

MiFID has introduced a pre-determined categorisation across Europe as a way to overcome the ISD's drawbacks: under the 1993 Directive the same client could fall under different categories depending upon the applicable national rules: firms contracting with similar clients in different Member States could be confronted to comply at the same time with different obligations[81], and this was counterproductive from the point of view of a vibrant cross-border market for investment services.

[81] For example, in the UK all companies had to be treated (and protected) as non-sophisticated clients, unless having called up share capital or net assets of 5 millions pounds; in Italy the same companies could be treated as professional (sophisticated) clients; for this purpose it was sufficient for their legal representatives to state the company's specific experience and knowledge in the field of financial instruments' transactions.

In some States – such as Italy – the categorisation provided was not sufficient to adequately mould the conduct of business obligations[82]. For example, it was clear that clients having a common categorisation as retail investors did not all need the same amount of information to take an informed decision. The *bona fide* judgment required from the part of the firm had to be translated in practice into some concrete guidelines, this task ended up on court, which nevertheless shared different views on the point.

The Tribunal of Genoa (ruling of 14 December 2005, n. 4981) and the Tribunal of Florence (ruling of 14 December 2005) rejected the possibility that firms could treat retail clients differently even when their financial capability was considerable (above € 500 000). Both courts hinted to the fact that these types of clients could be treated as 'professional' following their specific request for upgrading, although such grandfathering mechanism was not included in the law. For Tribunal of Mantua (ruling of 16 November 2002) the duty to inform the client about the risks entailed by the investments shouldn't be too strict when it comes to clients who have already invested the sum of around € 50 000 in financial instruments other than state bonds. Contrariwise, the same Tribunal (in the ruling of 18 March 2004) held the firm responsible for not having intensively informed the client about the risks of the investments despite her being what the judge calls a 'sophisticated' investor, with a exposure of around € 250 000 and a risky portfolio management invested for one-fourth in foreign instruments, and for half of it in shares. By the same token, the Tribunal of Venice (11 July 2005) and the Tribunal of Lecce (12 June 2006, n. 1105) held that the conduct of intermediaries should be more attentive when dealing with clients having invested the considerable amount of more than € 90 000. All this testifies the perceived need for some quantitative parameters which would allow firms to treat natural persons proportionally to their actual need for protection.

### VI.3. Further opt-out. Eligible counterparties at Member States' discretion.

Under art. 50 of the L2 Directive States can create a default rule following which the clients which are professional-by- default under MiFID[83] become eligible counterparties by default under the national implementation. They can also introduce the grandfathering (to eligible counterparties) upon request of the clients which are professional-upon-request (corporate clients and individuals). In this case, the qualification as eligible counterparty is only effective for the services and transactions for which the treatment as professional can follow the request (art 50 of the L2 Directive).

By so doing, MiFID gives response to two threats of the current regime. First, and as mentioned above, that the default is too stringent and, hence, costly, for certain clients.

Second, it recognises that the benefits of a common categorisation should be weighted against its major drawback.

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[82] The need for further specifications was nevertheless perceived by a number of Authors, among which Chionna (2005), pp. 36 ff., who believed that such specification could be justifiable in the light of art. 6 (2) of the TUF.

[83] Safe for the "other institutional investors whose ain activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions", Annex II, I, n. 4, which are not mentioned in art. 50.

Having a common categorisation fosters cross-border activities in that firms serving the same type of client in different jurisdiction do not have to comply to different sets of obligations (depending upon the national classification of the client). Nevertheless, the need for protection of different clients heavily depends upon the national markets and the idiosyncratic features of the agents thereon, so that levelling the playing field on this matter comes at the expenses of precision. Retail investors' financial literacy grandly vary across the EU, as well as their investment and savings attitudes; sophisticated clients drive in different ways the development of the market, for example by requiring to a larger or lesser extent new and tailored instruments and services.

The potentials for cross-border businesses triggered by MiFID do not change this: although the integration envisaged at the EU level also includes the possibility that clients as well move across Europe to purchase investment services, this is currently not the case. It is more of the firm to offer services on the (foreign) territory of the investor, so that national authorities still exclusively face their nationals and have to address their features.

Let us now analyse the two provisions of art. 50. The latter allows professional upon request clients to require for further upgrading: this gives due consideration to the fact that the pre-determined categorisation might not suit the circumstances, and overcomes the remaining of formalism of the rules applicable to professional clients putting investors' bargaining in the foreground.

The former allows States to consider (almost) the whole list of professional client as eligible counterparties. This depends on an *ex ante* judgment by the authorities, and gives account of the fact that- as mentioned above – categorisations need be set having the features of the national market in mind.

In both cases, clients lose the protection accorded by the suitability, appropriateness, disclosure, best execution and client order handling rules (art. 24 of the L1 Directive). As a consequence, the firm-client bargaining on these matters rules the relationship. Problematically, art. 24 waives – admitting that this is possible under national regulations – the application of the general principles of art. 19 (1) for these clients. To ensure that the clients who are accorded such light-touch regime are effectively aware of the bargaining effort they are required to put in place to protect their interests (irrespectively to the fact that their national authorities has considered them able to enact self-help measures), art. 24 (3), second subparagraph, of the L1 Directive requires the express confirmation that the client agrees to be treated as eligible counterparty.

Art. 24 (3), first subparagraph, instead, ensures that even when services are provided cross-border without branches, the competence of automatically grandfathering clients to the class of eligible counterparties remains with their national authorities. In fact, under the Home/Host allotment of competences of art. 31, when firms act cross-border on the basis of the free provision of services, the applicable conduct of business rules are those of the Home State. This could be understood as meaning that also the categorisation of the client with whom the firm acts cross-border depends on whether the Home State has exercised the option of art. 50. Instead, art. 24 (3) requires investment firms to "defer to the status of the [client] … as determined by the law or measures of the Member State in which that [client] … is established".

Clearly, all this comes at the costs of another of the MiFID's aims, that of repealing the multiplication of possible statutes for the same client in different jurisdictions. The conflict of law rules of arts 31 and 32 of the L1 Directive give the following results, if the Home State, unlike the Host State makes use of the permission of art. 50: the firm which provides services in the Host State through a branch to a large undertaking has to fulfil the professional regime; if the same client is served from the Home State on the basis of the free provision of services, the applicable regime becomes that of eligible counterparties.

**Conclusions.**

This Chapter was devoted to the solutions at disposal when the costs of the regulation risk not being off-set by its benefits. Proceduralisation, despite facilitating compliance for firms, and establishing a benchmark which can be easily verified by investors risks being source of high costs.

First, it can be a fertile ground for opportunisms. If intermediaries can escape responsibility on the sole basis of having formally complied with the regulation, the aim of concretely protect individual clients is frustrated. If clients can appeal to mere formal defectiveness of firms' behaviours to put contracts at stake, the smooth accomplishment of financial transactions is put at stake, together with the principle following which the risk inherent to investment activities should be borne by clients. Both forms of opportunism entail not only a redistributive effect, but also a welfare loss effect.

An highly detailed regulation has the benefit of making clarity as to the reciprocal rights and duties of contractual parties, and facilitates the adjudication of cases. It nevertheless entails costs any time the fast development of business practices risks not being closely followed by the regulator. Under this scenario, a detailed regulation might well not been able to capture all the declinations of the reality, and leave more voids than it can fill, bringing back the problem of exact evaluation and enforcement of parties' rights and duties.

The application of general clauses can off-set these costs. They are more the so important to supplement the regulation on principal-agent set-ups and conflicts of interest exploitation: they help bridging information asymmetries, contribute to the completeness of incomplete contracts, fill in the void left when it is difficult to standardise *ex ante* a conflict-free approach.

I have analysed the scope left by MiFID for the general clauses of fairness, professionalism and honesty. In my view, they can be extensively applied, although there are some indices in the regulation of the fact that the detailed conduct of business rules could exhaust their content. I have also argued that the rules as mould by national authorities (especially courts) can also be applied to incoming firms, without this constituting a restriction prohibited under art. 32 of the L1 Directive.

This solution sacrifices the harmonisation aim of MiFID. Not only the national understanding of these clauses can vary, but also the way in which they are managed does, in particular the interrelation between courts' and supervisory authorities' in their application. Nevertheless, I have highlighted a common trend, i.e. that of leaving the management of such clauses in the hands of supervisory authorities, which can be coordinated at the supranational level by CESR.

Default rules – i.e. rules which predetermine by default the starting point of economic players – are useful to overcome biases and lack of willingness or power to undertake self-help actions, such as bargaining over rights. The default could nevertheless be not cost-effective: its effectiveness crucially depends upon the exact identification of the features of its beneficiaries (and consequently of what they exactly need), since it could otherwise protect too much or too little and, despite the proper identification, it depends upon the ability of the regulator to assess what parties would have bargained for. When these evaluations are not accurate, a protective default – while minimising the costs of those players who would otherwise err – might well more than proportionally increase three types of costs: next to the individual costs for firms, which take the form of compliance costs and the individual costs for investors, namely the opportunity cost of not being able to undertake profitable transactions, one should also mention the social costs. In fact, when transactions are hindered the supply side of investments is diminished with two consequences: it fosters the development of new investment opportunities to a lesser extent; it deprives the economic system (the demand side) of smooth flows of capital.

MiFID's whole system of conduct of business rules can be considered the default for retail businesses, a default which can be avoided under the conditions and with the procedures provided for by MiFID itself, namely the grandfathering of retail clients to the class of professional clients.

To evaluate how accurate the default is as compared to the needs of the class of clients it applies to, I have analysed the broadness of the retail class under MiFID. It over-inclusiveness has been appreciated by comparing it to the Italian and English pre-MiFID regimes. I have pointed out that the current categorisation has the potential for stretching out to 99,8% of all non-financial businesses in the current EU-27.

I have also pointed out that the opting-out mechanism, through the grandfathering of retail clients to the class of professional clients is more currently difficult than it was under the pre-MiFID UK and Italian regimes (although the Italian one was highly controversial).

Lastly, I have evaluated the amount of rules which can be avoided through grandfathering, analysing the main features of the current professional clients' treatment as compared to the retail one. I have found that the waivers are limited, and much more limited than those possible in the UK and Italy before the new directive. In particular, such waivers closely meet the intermediaries' need to abate compliance costs; to a much lesser extent, they avert the costs arising when sophisticated investors are hindered from taking autonomous decisions. To counterbalance these strictness, and in recognition of the importance of national evaluations as to the sophistication of local clients, MiFID confers to Member States the possibility to grant further opt-outs. This, at the expenses of harmonisation, duly gives back to national authorities the power to judge as to the idiosyncratic features of the actors on their market.

# Chapter VII

## Enforcement Under MiFID.

### VII.1. A roadmap to MiFID's provisions.

It is normally held that the quality of regulation heavily depends upon the quality of enforcement it allows for.

Enforcement is crucial since it ensures that players bear the costs of non-compliant behaviours and are thereby forced to internalise the negative externalities they create. It therefore gives incentives for private players to pursue the welfare maximising results envisaged by the regulator[1].

Enforcement can be split-up into two concepts: public enforcement and private enforcement. The former involves or, better, is conducted by public authorities whereas the latter is realised through the interaction between (private) agents in the market, eventually through the medium of the judiciary body. For both, enforcement is not only a matter of punishment, but also a matter of control.

Both private and pubic enforcement measures can be classified on the basis of whether they take place before or after a breach of rules (*ex ante* and *ex post* enforcement respectively), and of whether incentives to a proper behaviour follow from either the threat of direct or indirect losses, or the threat of subsequent losses or market discipline (formal and informal enforcement respectively)[2].

In the context of intermediaries' conduct vis-à-vis investors, the abovementioned types of enforcement can take a number of forms.

*Ex ante* public formal enforcement roots in authorities' power to supervise businesses on a ongoing basis, and issue orders as to how the organisational features should be set-up, how employees should be instructed, how documents to be circulated should be drafted etc. It is a formal enforcement insofar as it obliges firms to undertake additional costs or change the already envisaged measures.

The *ex post* public formal enforcement allows authorities to issue pecuniary (administrative or criminal by nature) measures or restraining orders prohibiting the pursuance of some activities. While the former directly impact on the costs of the firm, the latter indirectly has the same effect, in that future businesses are prevented or restrained.

[1] See on these matters Sartori (2004), p. 15. The Author also mentions other positive side-effects of a proper enforcement. For example, it gives the incentives to complete incomplete contracts.

[2] This derives from the taxonomy proposed by Armour in the context of the UK corporate governance, and applied by Enriques to the Italian financial market. Their works define formal enforcement as that which involves judiciary or quasi-judiciary proceedings.

Among the *ex ante* private formal enforcement techniques *Enriques* mentions interim remedies[3], while the *ex post* private formal enforcement is based on litigation. Court decisions issued by the judiciary body upon the filing of a case by private individuals can give rise to a number of redress possibilities, depending upon whether the claim roots in a breach of fiduciary duties, of contractual or pre-contractual duties.

*Ex ante* public informal enforcement is implied in the fact that intermediaries know that the authorities are accorded supervisory functions which extend above their whole life-span and range of the business. This increases the probability of measures being taken as soon as firms depart from the standard conduct. In fact, enforcement is brought about also when intermediaries know that their supervisor can easily obtain information which could facilitate the adoption of *ex post* measures.

Importantly, *Enriques* mentions as an example of this enforcement strategies also the possibility for authorities to specify the content of the rules. By rendering this content officially clearer, they ensure that detection and punishment of breaches will become easier. With this insight, also the practice of organising informal meetings – commonly used by the FSA with UK intermediaries – can be said to attain the same aim[4].

*Ex post* public informal enforcement roots in the powers of authorities to issue private or public warnings as to behaviours which are not directly fined, but are signalled to the market or added to the record of the firm, so that their likelihood to be fined upon the subsequent breach arises.

As examples of *ex ante* private informal enforcement one can mention the case in which parties bargain on the inclusion of clauses which mould their contractual behaviour. As an example of *ex post* private informal enforcement one can mention the situation in which private parties sanction misbehaviours by discounting the price they are willing to pay or walk away from the party in breach of its duties.

Informal strategies are particularly hard to pursue in the field of intermediary-client relationships, when they rely on reputation mechanisms. The *ex ante* private enforcement mentioned above implies that investors know what they need and what the behaviour which the intermediary can undertake to provide them with what they need is, bargain for it and supervise its compliance. Since this is hardly the case for retail investors in particular, the law normally provides for the completion of the contract[5]. *Ex post* private enforcement, as well as *ex post* public enforcement (to the extent that it uses the tool of publicly circulated warnings) implies that intermediaries attach particular value to their reputation, the market can perceive it, correctly discount the price they are willing to pay to disloyal intermediaries or switch to different operators. It also assumes that investors do not have a collective action problem, in that they – rationally from an individual point of view – refrain from undertaking enforcement activities

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[3] Albeit not for the specific issue of beaches of conduct of business rules in the provision of investment services.

[4] From another perspective, these meetings could also have the aim of helping intermediaries understand when they can be considered compliant with the regulation: i.e. satisfy their intention of not breaching the regulation, even where it is more difficult to understand what a compliant behaviour could be. Also, in case where the information about possible negative externalities of an activity are not easy to gather, and all firms are interested in having them but no one is willing to undertake the investments for this purpose, the intervention of a public authority realises economies of scale and scope. See Giudici (2008), p. 97.

[5] See *supra* I.3.3 and I.4.3.

based on reputation assuming that the activity of other investors will be sufficient to oblige intermediaries to discount their price[6].

It follows, that the importance of formal enforcement, especially *ex post* enforcement, is uncontroversial[7]. This holds particularly true in principal-agent set-ups, whose inherent feature is the agent's *ex ante* freedom to act[8], and when the information asymmetry among contractual parties renders it desirable to leave the more informed party margin for manoeuvre[9].

Upon close sight, though, also some formal strategies of enforcement risk not being completely effective in this field. It is commonly recognised that the relatively small claims of private investors are not frequently brought to court; in lack of a mechanism for these claims to be coordinated, the expected loss of intermediaries which breach their duties diminishes.

On the other hand, a number of studies highlight the flaws of public enforcement in general. Public bodies might have weak or mixed incentives, suffer from a lack of information, and it might be easy for market operators to foretell their conduct[10]. The literature on authorities' incentives is immense. Altogether, it highlights the problems of alignment with the politicians' interests, the capture by the industry, the revolving door system, whereby personnel in the authorities becomes lenient toward private firms (or elaborate an intricate web of rules which they are the only one able to interpret) in the expectation of future working opportunities there[11].

Some works argue that pubic enforcement is ineffective and, hence, redundant. *La Porta, Lopez-de-Silanes, Shleifer* (2006)[12] reach the conclusion that financial markets' development is mainly backed by private enforcement. They conclude so by comparing the size of a number of countries' capital markets with proxies for public enforcement quality. These proxies have been criticised for too formally focusing on matter such as independence, investigation powers, range of sanctions at disposal of the authorities. *Jackson* and *Roe* (2008) find that employing different proxies (related to staffing and budget), a correlation can indeed be found[13].

As 'against' private enforcement, though, one can mention (next to the free rider and collective action problems above) the slowness of the judiciary system and the inability of courts to set an appropriate level of penalties. Judges as well might be subject to poor incentives and

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[6] See *supra*, Chapter I.

[7] It is nevertheless debated whether investors should be accorded civil remedies for some types of breaches: Giudici (2008), pp. 247 ff., mentions the provision of false information to the secondary market: if false information is dispersed, one (the informed) party can trade upon the correct information and gain to the detriment of the party which trades on the false information. This does not destroy value (as in the case of misleading information provided to the primary market, where the damage suffered by the individual corresponds to a social damage), but just shifts welfare. Since diversification can avert this risk, there is no unavoidable damage to bridge.

[8] Enriques (mifid), p. 13.

[9] Sartori (2004), p. 15. As mentioned above VI.1.2., effectiveness of private formal *ex post* enforcement is also a function (among other things) of legal precision, whereas a too intricate web of regulatory provisions can hinder it: Parisi, Fon (2007), p.17.

[10] Giudici (2008), p. 102.

[11] See for a literature review Giudici (2008), p. 104.

[12] As well as Djankov *et al.* (2008) and Word Bank (2006).

[13] Hence, a question of causality arises: does a strong public enforcement give rise to developed markets, or do development markets call for a more efficient public enforcement?

affected by lack of information[14]. As seen above, incomplete contracts benefit from effective enforcement, which gives incentives to the completion of contracts; but if judiciary bodies do not feature the expertise necessary to understand the business environment and the parties' behaviours, parties have incentives to leave the contract incomplete[15]. The onus of proof on investors risks being burdensome in the filed of investment services, since they risk being required to prove not only fairly technical circumstances, but also circumstances which are mainly internal to the firm (such as its organisation).

Furthermore, *Giudici*[16] finds a misalignment between individual claimants' private incentives and social benefits in private suits: since the plaintiff does not pay the costs for the judiciary system, and only limitedly pays the defendant's costs, he might have incentives beyond what would be the social optimum. Furthermore, he points out a cream-skimming effect, i.e. the threat that private enforcers only act against parties which can refund the damages, ignoring other breaches. As for public enforcement, also some works on private enforcement have empirically pointed out that it is unimportant in developed securities markets[17].

On the contrary, the ides that public and private enforcement shall supplement each other has recently started appearing in the literature. Scholars argue that public enforcement supplements private enforcement in that it is able to impose sharp financial and reputation penalties[18], while private enforcement supplements pubic enforcement in that it is triggered by more informed parties, which can act as watchdogs of the industry[19].

The conclusion backed by a number of scholars is that the existence and cooperation between the two in necessary. Not only because when one fails, having a sub-optimal form of the other is better than having no enforcement at all[20], or because their sanctions can sum up together to determine an effective level of deterrence[21], but also because they positively impact one on the other, and the two can develop – if coupled together – to an optimal system. On the one side, "good public enforcement can contribute to the efficacy of private enforcement"[22]; for example, authorities can monitor and gather information on the businesses on an ongoing basis. On the other side, if authorities systematically underestimate the unlawfulness of certain behaviours (because of lobbying, limited resources or inability) firms have the incentives to ignore part of the

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[14] Jackson, Roe (2008), p. 2, point out that many suits depend on the information gathered by public enforcers, and mention those on insider dealing for which evidence about irregular price movements must be provided.

[15] See *supra*, Chapter I.3.3.

[16] Giudici (2008), pp. 104-105.

[17] Armour *et al.* (2007). They evaluate the intensity of private lawsuits which are started and not dismissed by the courts on the matter of company and securities laws in the UK and the US, and find that their number is nearly nonexistent.

[18] Jackson, Roe (2008).

[19] Shavell, (1984), Giudici (2008), p. 97,

[20] Jackson, Roe (2008). An example of this can be found when the same rules can be enforced by means of both public and private enforcement. In Italy and the UK, for example, breaches of the conduct of business rules ground both the issuance of public sanctions and the adjudication of losses under contractual law. See Stella (2008)

[21] Giudici (2008), 102, nevertheless highlights the risk that this mechanism could create a case of over-deterrence. While in Italy the penalties issued by the public supervisor do not automatically trigger a (judicial) relief of losses suffered by individual investors, in the UK the FSA can also dispose payments which go to the benefit of individual investors. See Stella (2008), Pampurini (2007), pp. 125 ff.

[22] Jackson, Roe (2008), p. 2 and 28.

regulation. This is not the case when the control comes – through the civil proceeding – from different parts[23].

**VII.2. The new European framework.**

MiFID contains rules which more or less directly impact on the issue of enforcement[24].

Nevertheless, the enforcement strategies which touch upon reputation are not particularly emphasised by MiFID. Pursuant art. 51 of the L1 Directive, Member States only have to give authorities the option (not the duty) to make public measures or sanctions adopted against infringements, safe, of course, where disclosure would "seriously jeopardise the financial markets or cause disproportionate damage to the parties involved".

Many among the abovementioned aspects of enforcement also not considered. This is the case for the onus of proof, the level of sanctions which can be issued, the aggregation of small claims[25].

Other aspect are touched upon only by way of minimum harmonisation. The discussion on whether the directive could have gone further goes beyond the scope of this work, since it should take into consideration whether the Treaty grants to the EU bodies the power to affect private, administrative and procedural laws of the Member States. It is nevertheless worth it mentioning them here.

Collective action problems are touched upon by art. 52 (2) of the L1 Directive. Member States have to accord to public bodies or their representatives, or to consumer organisations having a legitimate interest in protecting consumers, the right to take action before the courts or competent administrative bodies. This is subject to the condition that such groups act in the interest of consumers and their aim is that of ensuring the compliance with national provisions implementing MiFID. Art. 53 of the L1 Directive simply recognises the necessity of measures facilitating the setting up of out-of-court settlements. It is nevertheless left to Member States to achieve this aim, without further indications.

On the contrary, MiFID more extensively (directly or indirectly) touches upon issues of both private and public enforcement. As far as private enforcement is concerned, my view is that it renders more difficult for consumers to seek redress, due to its lack of coordination with the Rome I convention. In particular, there is ambiguity as to the applicable regulation.

On the other side, public enforcement has been ameliorated as compared to the ISD, while it remains unclear whether private and public enforcement can nowadays effectively cooperate.

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[23] Stephenson (2005).

[24] I shall warn that the provisions of arts 31 and 32as well as those from 48 to 53 of the L1 Directive do not apply to banks.

[25] In most cases nothing is said. Concerning the level of sanctions, art. 51 of the L1 Directive only requires States to allow public authorities to adopt "appropriate administrative sanctions". Nothing prohibits that the same breaches are sanctioned though public measures and also give rise to contractual responsibility, if national transpositions render the rules relevant under private law, but this is completely left to national legal systems. Kruithof (2005), pp. 30-31, expresses concerns with respect to the lack of uniformity this triggers.

### VII.2.1. (Ex post formal) private enforcement.

Let us consider the case of an Italian customer being provided with services in Italy by a French intermediary. MiFID itself does not lay down the rules for identification of the competent court in investors-firms controversies. The identification can nevertheless take place thanks to another European regulation, the so-called Brussels I Regulation[26]. This refers the matter to the jurisdiction where the consumer is domiciled, Italy in our case (art. 5).

The competent (Italian) judge will then have to identify the applicable rules. At this stage not the content of the rules themselves is relevant, but the jurisdiction to which the applicable rules belong. For this purpose, the so-called Rome I[27] and Rome II[28] conventions have to be applied.

In absence of an agreement, contractual obligations are governed by the law of the country where the client has his habitual residence, provided that the firm pursues its activities in – or directs its activities to – the same country (recital 26 and art. 6 of Rome I) and pre-contractual obligations shall be regulated by the same law applicable to contractual obligations. Therefore, the Italian contract law applies.

For conduct of business rules something different holds. If the intermediary is acting in Italy without establishment, in compliance to art. 31 (1) of the L1 Directive, Italian laws *renvoi* to French conduct of business rules.

This is a fairly easy solution, and a simplification MiFID has brought about in comparison to its forerunner. Under art. 11 of the ISD, the applicable rules were those of the member State where the service was provided. Such concept could be interpreted as referring to the State where the investor resides or to the State of the market where the transactions are executed, to the detriment of legal certainty and clarity[29]. In the example above, it would be not easy for the Italian judge to decide which law it should apply.

Nevertheless, if only one considers that contract law and conduct-of-business rules overlap to a non-negligible extent, although the former still exceed the latter, the matter appears far more complex than it is at first sight. MiFID's rules refer to private law concepts, such as conclusions, amendment, termination of contracts without harmonising them[30]. For example, art. 29 of the L2 Directive mandates the provision of information "in good time *before a … client … is bound by any agreement*". This is a non negligible source of ambiguity in the identification of the applicable rules and their outcome.

In the case above, MiFID's conduct of business rules should be applied as in their French implementation, but what about, let's say, the rules on how the contract is concluded? Pursuant Rome I, they should be those of the place where the consumer is domiciled, Italy. But one could also argue that since the French implementation of art. 29 of the L2 Directive is called upon, also its understanding of what is considered provision of information "in good time *before a … client … is bound by any agreement*" is.

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[26] Regulation 44/2001of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (OJ EU of 16 January 2001 L 12/23).

[27] Regulation 593/2008 of 17 June 2008, OJ EU of 4 July 2008 L 177/6.

[28] Regulation 864/2007 of 11 July 2007, OJ EU of 31 July 2007 L 199/40.

[29] Herbst (2003), p. 212.

[30] CESR (2005a), p. 61.

It is also possible that the level of protection a client could – at least on average – expect from MiFID is circumvented. Rome I convention allows the parties to a contract to freely decide which national contractual rules should apply to their transaction.

With the purpose of depriving the client of the level of protection granted by MiFID, the intermediary could impose her a clause which makes applicable the contractual rules of a non-EU State, for example a rule which does not burden firms with any information duty.

MiFID does not clearly contain a provision addressing this problem. It could be overcome appealing to art. 3 of the Rome I convention itself: when all the elements relevant to the contract point to a country other than the one whose law has been chosen, parties should respect the mandatory[31] contractual rules of that other country.

Imagine a firm established in Member State A, providing services through a branch in Member State B to a client resident of Member State C, with whom it contracts to apply the contractual rules of a non-EU State. It is difficult to identify in one of the mentioned EU States the State 'to which all the elements relevant to the contract point'. Hence, art. 3 would not offer a safeguard against such exploitative behaviour.

One could still argue that the conduct-of-business rules should be levelled by MiFID in all those States, and that national border become irrelevant, so that all the elements do point to Europe and to its uniform system of conduct-of-business rules. Nevertheless, this solution is at risk of being rebutted: first, art. 4 of the L2 Directive allows States to impose more stringent requirements and might, to a certain extent, contradict the existence of a true uniform European system for conduct-of-business rules; second, at least some of the conduct-of-business obligations are clearly modifiable by the parties and do not fall under the category of mandatory contractual rules[32].

#### VII.2.2. Public enforcement.

MiFID contains a number of useful provisions on public enforcement. In particular, it approximates the powers which national authorities shall be accorded and reinforces their collaboration. These provisions directly address the problem of uneven safety among investors in different jurisdictions and distrust contagion beyond national borders.

To assess the quality of the new framework on this point, one should briefly refer to its forerunner.

There was always the problem of dual supervision: firms were subject to the supervision of both Home and Host States (for prudential and conduct of business matters respectively) any time they performed services abroad, regardless to whether they acted with or without establishment.

[31] The rules which cannot be derogated by agreement.

[32] For example, if the client does not provide information on his financial needs, firms do not have to assess the adequacy of the investments.

The concept of 'Host State' for this purpose was not clear, since art. 11, referred to the 'member State' where the service is provided, and this could be interpreted as the State of the client, of the market on which the transactions were performed etc.[33].

Dual supervision is a particularly sensitive matter. It implies that the Home State's authority exercises control in another State's jurisdiction and that the Host State applies measures to a firm which is not its national. From a legal point of view, this might be problematic, unless explicit provisions confer specific powers upon States.

Host States could require information and conduct on-site inspections (arts 17 (3), 18 (2), 19 (2) and 24 (3)) to carry out their duties. The ISD also attempted to coordinate the supervisory activities of national authorities: States were to exchange information on request and carry out on-the-spot verification on behalf of other States (arts 23 and 24).

Nevertheless, enforcement of conduct of business rules was in practice allotted with preference to the Home State. A Host State detecting a breach of rules for which it was competent could merely ask firms to put an end to the illicit practice; the Home State was the sole authority able to apply sanctions against non-compliant firms. The Host State's authority was residual in the sense that it had the possibility to intervene exclusively in case of emergency or after the Home State's measures had proven inadequate (art. 19 (3), (4), (5))[34].

MIFID regulates the supervision of firms and the enforcement of applicable rules more accurately than the ISD[35].

It restrains dual supervision to branches, which are subject to their Home State's authority for prudential matters and to the Host State's authority for transactional matters. Home States are empowered to conduct on-site inspections on branches abroad (art. 32(8) of the L1 Directive). Host States can require information from branches set-up in their territory (art. 61(2) of the L2 Directive), ask for variations to business arrangements before the branch starts operations if they are not satisfied with the proposed arrangements (art. 32(7), second subparagraph of the L1 Directive), and ask to put and end to breaches of conduct-of-business rules when branches are already in place (art. 62(2) L1 Directive). In addition, MiFID allows Host State's authorities to take direct measures against detected breaches, even though they are not explicitly bestowed the power to conduct on-site verifications.

This system is far more practical and effective than the one previously in place, but implies that national authorities trust each other and that supervisory practices across Europe converge[36]. To this end, arts. 48 ff. of the L1 Directive identify the powers which all jurisdictions shall grant to their national authorities: the power to access documents and records; to demand information; to carry on-site inspections; to require the cessation of prohibited practices; to request the freezing or

[33] See *supra* II.2.1.4..

[34] The need for increased emphasis on the problem of the proper allocation of regulatory and supervisory powers in the EU was expressed by Authorities just before MiFID's enactment: OECD 2000; European Commission 2000. See also Pacces (1999), p. 6.

[35] In the ECB (2007), p. 10, words: MiFID "adds clarity to the allocation of responsibilities between the home and host authorities".

[36] CESR (2004a), p. 12, points out that the provisions only name the minimum powers to be accorded to Authorities, to which Member States can well add.

the sequestration of assets and the temporary prohibition of professional activity; and the right to issue administrative sanctions[37].

MiFID greatly expands Home States' responsibility. In effect, Home States supervise their national firms acting abroad without establishment. This raises concerns that authorities may be overloaded and encounter difficulties in detecting breaches outside their territory[38].

The CESR Himalaya report[39] expressed concerns as to: whether the Home State authority has enough resources to supervise compliance to conduct of business rules in all Host States, and the Home State investor compensation scheme is sufficient to compensate investors spread out in different member States. Finally, it underlined that the mutual recognition of the decisions of another authority implies confidence in this authority's competence.

Scholars also raise the doubt that the expansion of Home States' competences means that supervisors will choose to focus on detection of breaches in national markets rather than in foreign markets, not only for lack of information but also for 'political reasons'[40].

To counterbalance the possible negative effects on the quality of supervision, the European regulation contains rules reinforcing the collaboration mechanisms and assigning Host States an auxiliary role in supporting Home States' supervision. Under the ISD, Host States' authorities were mandated to inform Home States' supervisors only on the measures taken against breaches they were competent for, that is breaches of the conduct-of-business rules. Other information was exchanged on request.

Art. 62 of the L1 Directive mandates that where Host States believe that firms acting within their territory are in breach of duties for which the Home State is competent, they shall refer their findings to the Home State. If the measures adopted by the Home State are inadequate, the Host State itself can take actions to protect investors and the proper functioning of the market. Thus the Host State may acquire supervisory and enforcement powers that would normally fall under Home States' competence.

In addition to that, all States can guard against misconducts, even those conducted outside their territory and for which they are not competent, and inform the competent national Authority thereof (art. 56(4) of the L1 Directive).

These provisions can address some of the causes of public under-enforcement: if national authorities are lenient toward a certain behaviour because they have traditionally flowed this line, or because a national lobbying has obtained it, foreign authorities can act as watchdogs against particularly dangerous conducts.

The particular attention devoted to cooperation among authorities also translates in the authorities' duty to exchange information, and collaborate in the performance of on-site

[37] Despite this, since the level of sanctions is not harmonised, practices vary grandly across Europe. To keep track of the current situation, CESR has recently undertaken a review of MiFID-related supervisory practices and sanctioning Regimes. The report shows that administrative sanctions range from a minimum of €12.550, in Luxembourg and can be unlimited in the UK and Denmark. The criminal sanctions range from a minimum of € 5.000 (in Bulgaria), and can be unlimited in the Czech Republic, Germany, Denmark, Finland, Iceland, Norway and the UK. CESR (2009), p. 14.

[38] CESR (2006), p. 9. The Commission (2000), p. 11, stresses this concern, since it recognised that "supervisory resources are a scarce commodity".

[39] CESR (2004f).

[40] Enriques (2005).

inspections and other investigations. Collaboration cannot be refused maintaining that the investigated conduct does not breach any national regulation.

MiFID spells out the core principles guiding States' cooperation (arts 56-58). Following CESR's guidance, States can agree on joint supervision, and they can delegate or 'outsource' supervision under the condition that each retains its responsibility[41]. Concretely, this might take place under two forms: the 'Common Oversight Request' through which a State requests an agreement on a common oversight programme; the 'Standing Request for Assistance' used to solicit the assistance of another authority on certain supervisory matters. Both cooperative measures are subject to the principles contained in CESR's 'Protocol on the supervision of branches'.[42]

Although States can decide how to implement the principle of cooperation, the margin of manoeuvre shall not result in member States refraining from acting and frustrating any concrete result. Therefore, art. 59 of MiFID makes clear that States can refuse a request for cooperation for investigation, on-the-spot verification or supervisory activity only on limited grounds: where the activities could adversely affect the sovereignty, security or public policy of the State; where the matters which should be investigated are already being evaluated in judicial proceedings or a decision thereon has already been taken with a final judgment.

### *VII.2.3. Cooperation between private and public enforcement?*

As pointed out in the outset, the interaction between public and private bodies entrusted with enforcement duties is crucial. In particular, the efficacy of private enforcement could be heightened allowing courts to share the information at disposal of public authorities. This would allow for economies in the costly process of information gathering, would help reduce the lengthiness of civil proceedings and ease the position of the investors/claimants. Thereby, the probability of measures being taken against breaching intermediaries would increase.

MiFID contains some provisions which touch upon this issue, but they are fairly. Safe for the cases covered by other provisions of MiFID, art. 54 (1) of the L1 Directive seems to be restrictive about the exchange of information between competent authorities and any other authority, physical or legal person. The idea of professional secrecy is stressed, and the only exception arises when the transmission of information takes place in summary or aggregate form, i.e. a form which would serve no purpose in the curse of a civil ruling. The prohibition is reinforced by para 2 of the same article: confidential information can be divulged in civil or commercial proceedings only in cases of bankruptcy or compulsory winding up.

Nevertheless, under para 5, competent authorities might exchange or transmit confidential information which has not been received from a competent authority of another Member State *in accordance with national law*. To whom, then, authorities can exchange and transmit information on this basis?

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[41] CESR (2007c).

[42] To date, thirteen bilateral standing requests for assistance have been concluded, as well as a common oversight programme between the UK (FSA) and Germany (BaFin): see CESR (2008).

If it were competent authorities of another Member State, this would be repetitive of art. 50 (and indirectly of art. 54 (1)) under which, in accordance with national law, national competent authorities are under the right/duty to require/provide information to each other.

If it were other competent national authorities (each State has indeed the right to identify more than one for the supervision of different provisions), meaning that the national law, if any, applies to the information exchange among them, the provision would consistently water down what elsewhere (albeit only in the preamble) envisaged on this issue: "it is necessary to *reinforce* provisions on exchange of information between national competent authorities and strengthen the duties of assistance and cooperation which they owe to each other" (recital 63 of the L1 Directive, emphasis added).

Probably, then, MiFID does not prohibit the transmission of information between authorities and other national bodies. The opposite would also be problematic under the UK system of enforcement: the FSA conducts the investigations on possible breaches but, after that, the procedure is completed in front of another authority, the Regulatory Decision Committee, which is an administrative body distinct from the FSA, whose personnel has no employment lien with the Authority[43].

**Conclusions.**

The aim of this Chapter was evaluating the efficiency of enforcement under MiFID. The first paragraph has considered the types of enforcement, their relative strengths and defects and the need for cooperation between public and private enforcement to provide a roadmap of the analysis of MiFID.

The analysis of the new directive has allowed to make the following points: enforcement strategies based on reputation are only marginally touched upon, while the effectiveness of private enforcement is indirectly diminished by the lack of coordination between MiFID and the Rome I convention. Public enforcement is sharply ameliorated as compared to the ISD: the new directive rationalises the allotment of powers between Home and Host States, endeavours to level the instruments at disposal of national authorities, creates a system of cooperation. Nonetheless, it remains unclear whether private enforcement can benefit from an information flow coming from pubic authorities.

[43] See Stella (2008), p. 143.

# Chapter VIII.

## Retail Investors' Protection in Light of Some Recent Financial Markets' Trends.

### VIII.1. Substitutability of products and uneven regulation on the matter of conflicts of interests.

Over the decades, one of the most prominent trend of financial markets has been the development of new instruments, devised either to meet different needs, or as substitutes to other investments. The new instruments have ended up spreading among retail clients as well, which have familiarised with their features and started perceiving them as substitutable, sometimes irrespectively to their inherent features[1].

There is no common understanding as to what should testify substitutability of products: the more extreme opinion holds that this concept heavily depends upon the characteristics and needs of the end investors so that any substitutability can hardly be detected[2]. A less restrictive approach takes several objectives factors into consideration: the existence of an investment (as opposed to protection) component and the risk/return characteristics of the products, the typical 'vesting period', the rights conferred upon investors[3]. A more comprehensive approach has also regard to the economic function of the investments, not only its *de facto* economic function but also the economic function which is perceived by the end purchasers[4], and their relative diffusion. On these grounds, the more prominent examples of investments substitutable with MIFID-relevant financial instruments marketed through the provision of investment services (as well as one-another) are unit-linked insurances and units in collective investment undertakings[5].

Substitutability creates the need for a comparable level of protection across products in order to: ensure that investment decisions are taken on the sole consideration of the clients' financial needs; avoid that clients' lack of confidence spreads across products, and that intermediaries arbitrage among product-specific regulations.

In the following part, I aim at assessing whether such level of protection is uniformly set across products, with particular reference to the problem of conflicts' exploitation. Anticipating that the answer is in the negative, I show that investors in (unit-linked) life insurances and in

[1] European Commission (2008a), p. 7, refers to "blurring borderline between investment products and the opening architecture in EU financial distribution".
[2] European Commission (2008a), p. 16.
[3] European Commission (2008a), pp. 16-17.
[4] The circumstance that products can be placed by the same entities clearly plays a role in the investors' perception of substitutability.
[5] One should not neglect the various attempts to stress the difference between unit-linked life insurances and UCITS: European Commission (2008a), p. 16 and GDV (2007).

UCITS' units are threaten by more (unresolved) conflicts of interests than investors in other financial instruments.

The marketing of unit-linked insurance products by investment banks and intermediaries are less heavily regulated (by the provisions of the Insurance Mediation Directive) than the performance of investment services. The diffusion of UCITS' units by investment firms and banks does indeed fall under MiFID's provision. Nevertheless, the chain of creation, management and distribution of UCITS gives rise to peculiar conflicts which should be addressed, partly with tailored MiFID rules, partly with more detailed provisions on UCITS managers to which MiFID does not apply.

As a consequence, clients additionally face the threat that intermediaries preferentially allot the less regulated and more profitable financial products, although they are not best suited for the investors' needs. Upon closer sight this also amount to a conflicts of interest exploitation, which no provision avoids[6], since no provision burdens intermediaries to consider the full set of possible investments when advising – or acting on behalf of – their clients[7].

### *VIII.1.1. Unit-linked insurances.*

Unit-linked products are life insurance products with an investment component: "the policy holder decides on his policies asset allocation made by the insurance company on his behalf and bears the investment risk"[8]. Thereby, they "provide for potential higher capital at the price of higher risks"[9]. Among Member States, their popularity has increased by 3.5 percentage points in the two years between 2003 and 2005. In some countries, such as the UK, they account for more than 57% of the total life insurance products and have gained popularity in substitution of investment funds[10].

[6] Art. 88 of the Italian regulation (Consob's regulation 16190) seems to confront this problem: it states that intermediaries who distribute financial products issued by banks and insurance companies and also place financial instruments and/or provide investment advice thereon should globally evaluate their relationship with the clients, in order to comply with the conduct of business rules in a way which is uniform and coordinated.

[7] I incidentally also make another point: when the performance of identical services is subject to different rules depending upon the agent performing them, the competition in the market is externally influenced. This happens to be the case for the marketing of UCITS' units, depending upon whether it is conducted by MiFID-relevant intermediaries or funds' managers, to which MiFID does not apply. This aspect is nevertheless difficult to appreciate: the regulations make the different entities subject to different rules on capital endowments, organisation structure and operational conditions, which can partly justify a dissimilar treatment in terms of the application of conduct of business rules, and for sure weigh more on the business decisions, including the entry in the market, than the rules on conduct do.

[8] BME (2007), p. 65.

[9] BME (2007), p. 65.

[10] BME (2007), p. 67.

They can be distributed not only by insurance companies and their agents, but also by investment firms and banks[11]. Their structure, together with their distribution channels, play a role in the perception of these products as substitutable to the financial instruments on which investments services are provided. Nevertheless, MiFID's regulation does not apply to them, since they are not listed among the financial instruments of Annex I Section C to the L1 Directive.

Relevant rules are to be found in Directive 2002/92/EC, applicable to the distribution to all life insurance products[12]. It addresses some of the conflicts insurance mediators face with respect to their clients, albeit differently from MiFID. Conflicts arising from business or link relationships between distributors and insurance companies, possibly leading to the provision of advise biased toward a specific insurance contract are ruled by art. 12. Insurance intermediaries shall disclose to the clients whether they have holding which represent more than 10% of the voting rights or capital in a given insurance undertaking, or whether their capital or voting rights are held for the same amount by one of them.

In the same vein, the intermediary should disclose whether contractual agreements are in place, on which basis its conducts its mediation activities exclusively for one or more insurance undertakings. When the firm declares its advice to be based on a 'fair analysis', and thereby possibly gains the highest level of trust from the part of the investor, it should consider "a sufficiently large number of insurance contracts available on the market" and evaluate the adequate one for the consumer's needs[13]. The advice given should always be justified, before the conclusion of the agreement. When the intermediary does not make any representation as to whether it acts on behalf of named insurance companies, or on the basis of a fair analysis, the customer is entitled to know the names of insurance undertakings which it conducts businesses with.

This conflict of interest regulation is fairly simple and clearly codifies the actions to be taken from the part of the intermediary, and the rights of the investors. It specifically targets the threat that business reasons lead the conclusion of the contract and relies on the clients' informed consent.

It is less detailed than MiFID regulation[14] on prominent issues, such as the evaluation of products' adequateness; for example, the IMD does not lead intermediaries in this assessment by itemising the information which should be obtained from the client. Such approach leaves open the threat of uneven treatment of clients across Europe, and enhances legal uncertainty, especially insofar as the States where the intermediation takes place (under the free provision of services or

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[11] BME (2007), p. 67 reports that bank represent the primary distribution channel. Together, banks and financial institutions play a major role in distribution of life insurances in countries such as France, Spain, Italy, Portugal, Belgium: European Commission (2007staffwd), p. 43.

[12] Directive of 9 December 2002, in O.J.E.U. L 9 of 15 January 2003 (hereinafter: 'IMD').

[13] Market practices which have arisen in compliance with these provisions do not fully satisfy supervisory authorities. The FSA, for example, is concerned by the fact that clients are poorly informed about the extent to which the intermediary searches the market: FSA (2008c), p. 4.

[14] One respondent to the Commissions' call for evidence on substitutable products pointed out that the rules for insurance products are more stringent than those of MiFID, sine "'execution only' sales are not permitted [for the former] and there are no appropriateness (as opposed to suitability) tests": European Commission (2008a), p. 23. The majority of respondents still viewed the rules for insurance products as less stringent than those for financial instruments.

through branches) can enact more stringent rules (art. 12 (5))[15]. Both the threat and the uncertainty are nevertheless likely to be overcome by the mechanism of art. 12 (5) third subparagraph: stricter rules shall be communicated to the Commission, which is therefore put on a better footing for bringing action against the States which appear to implement protectionist measures, and to the consumers and the insurance intermediaries, which can keep track of the risks and compliance costs triggered by cross-border provision of services.

The relevant regulation does not contain explicit reference as to how commissions and fees should be treated, although they have the same causal effect on the intermediary's behaviour in the placement activity as its business relationships do[16]. A number of studies have pointed out the need for additional reflection on the point: "while it is true that the information requirements for intermediaries stipulated in the IMD increase transparency in relation to the status of the intermediary and the basis of the advice offered, the IMD does not … contain any transparency provisions in relation to intermediaries' remuneration or to intermediaries' provision of services to insurers, both of which can constitute sources of conflicts of interest"[17].

The remuneration structures vary grandly in the business practice, giving rise to different concerns as to conflicts' exploitation[18]. Surveyed on this, European intermediaries have given account to remunerations based on commission, contingent and profit commissions, client fees and other revenues from clients. Commissions are monies paid by insurance companies to intermediaries as a percentage of the premium paid by the insured; client fees are paid by the insured, (instead of or) additionally to commissions. They relate to the provision of additional services, such as claim and risk management. They can add up to other revenues for services offered to the insurers themselves[19]. For both of them it would be in the best interest of investors to know how they are charged, and to what extent their monies is employed to pay for the intermediary services. Contingent commissions are paid from insurance companies to non-exclusive intermediaries on the basis of the achievement of certain targets of business levels; similarly, profit commissions are related to profitability of the business, and represent a sub-category of contingent commissions if paid to non-exclusive agents. Disclosure of both would be useful for investors to understand whether and to what extent insurance companies can align the intermediaries' preferences to their own and, hence, conflicts of interests might be exploited.

Also, the range of operations brokers undertake for the account of insurance companies can determine a producer-bias when they suggest or advice on the purchase of insurance policies. Dual role of brokers should also be more closely considered. Throughout Europe, intermediaries work not only as distribution channel, but also provide additional services to insurance companies, such as advice, handling of the clients' claims, assessing possible risks outcomes, collection and accounting for premiums: more than 35% of all brokers across the EU provide the

[15] Safe for the application of community regulation and case-law on the measures which unduly diminish the Treaty freedoms.

[16] The US Attorney General of New York has recently reached with a prominent insurance intermediary a settlement for 2m $: the company was found to receive from insurance companies payments in exchange for steering to them the business. Some of these commissions were disguised under the form of payments for additional services, charged well above their market price. The Settlement can be found at www.oag.state.ny.us/media_center/2006/jan/jan05b_06.html.

[17] European Commission (2007b), p. 66.

[18] Malcolm *et al* (2002).

[19] Commissions rank first in the standard of business across the EU, but are decreasing as compared to client fees, which rank second: European Commission (2007b), p. 55.

full set of services to insurance companies; more than 50% thereof provide brokerage services together with risk modelling and surveying, accounting services, administration of policies and claims, underwriting[20].

The unquestionable economies of scope entailed by the cumulative provision of different services, and the possibilities that these also go to the benefit of insured – in terms of both a better perception of the market and the clients' needs, and the possibility that costs savings are passed on to them – renders it very difficult to back the option of businesses' separation. On the contrary disclosure remains a viable tool, especially insofar as it clarifies the status of the intermediary, i.e. the capacities in which it acts for insurance companies[21].

Unit-linked products also feature additional possibilities for exploitation: first, the lack of pre-contractual information about the investment part of this insurance, its features and risk/return perspectives leaves the investors unaware of important characteristics which might not suit their best interest. Intermediaries have therefore more possibilities to place them, when the fulfilment of their interest so requires.

One of the reasons why intermediaries themselves might have incentive to place such products is the remuneration they receive from fund managers. As for all other type of remunerations, this information also remains undisclosed to insured[22].

In addition to this, under art. 23 (1) A lett. d) of Directive 2002/83[23], insurance companies can cover their technical provisions with UCITS' units. This might render insurance companies interested in the widest diffusion of units of the same funds among insured, where this amounts to an increased value of their technical provision and, hence, eases the fulfilment of stringent capital requirements without need for additional immobilisations.

Individual countries have promoted their own initiatives to address the lack of protection: respondents to a Commissions' public consultation highlighted that "intermediaries that provide advice on the basis of a fair analysis have to disclose the commission received for insurance placed on behalf of a commercial client upon request of that client (in the UK), or upon request where the insurance premium exceeds EUR 20000 (in France)"[24]. The Commission itself nevertheless found that across Europe, the cases of disclosure upon request largely outweigh those of voluntary disclosure from the part of intermediaries and that, in some cases, even after the request, only a small minority of investors are provided with information[25].

In the UK the Financial Services Authority itself has shown dissatisfaction with the current level of transparency and has therefore commissioned an independent report on possible alternative measures. In December 2007, the report by CRA International found a (high) level of clients' unawareness as to the right to obtain information about remuneration structures. The report nevertheless pointed out that the costs of introducing mandatory disclosure rules would outweigh the benefits. Following the report, the FSA issued a Discussion Paper envisaging three possible courses of action: more rigorous supervision and enforcement of current standards,

[20] European Commission (2007), Business Insurance Survey 2005-2006.

[21] FSA (2008c), p. 20.

[22] Respondents to a Commission's call for evidence expressed concerns as to the lack of transparency on the double layer of commissions embedded in unit-linked products: European Commission (2008a), pp. 14, 19, 21 and 25.

[23] Directive of 5 November 2002, published in O.J.E.C. L 345/1 of 18 December 2002.

[24] European Commission (2007b), p. 66.

[25] European Commission (2007b), p. 58.

enhanced regime allowing customers to request information, measure mandating the disclosure of remuneration structures.

Despite these efforts, the matter should be solved at a common, supranational, level. Times seems ripe for that. In response to a Commission's call for evidence on retail investment products, many national authorities specifically highlighted the existence of "'gaps' in existing pre-contractual disclosures for unit-linked life insurance, particularly with regard to conflicts of interest"[26], and several respondents have declared themselves ready to back the adoption of a common legal prohibition to contingent commissions[27].

It is questionable whether disclosure alone could be sufficient to tackle with the multifaceted problem of conflicts of interest, but would be a starting point. A part specific prohibitions, initiatives should be taken in order to ensure mandatory disclosure – or higher clients awareness as to their right to ask for disclosure – on identifiable and separately stated items. The disclosure should be comprehensive, in order to avoid indirect payments and take place in a standardised format, in order to promote comparability of products.

Disclosure being a priority in the supranational agenda brings also the matter of conflicts of interest management by means of organisational arrangements in the foreground. The European Directives do not go very far in addressing the question of organisation, and conflicts management by this means. Recital 32 and art. 19 of Directive 2002/83/EC only require separate management of life and non-life policies, and Directive 2002/92/EC treats the matter of business organisation to exclusively ensure professional and capital guarantees.

Contrariwise, some Member States rely on organisation as a means for conflicts' management. In the UK, parts of the FSA's Handbook regulating financial activities apply to insurance companies as well. This is the case for Prin 2.1.1. R Principle 8 on conflicts of interest, as specified by SYSC rules, in particular SYSC 10 on the identification and management of conflicts by means of organisational measures. Against this backdrop, exclusively concentrating on uniforms rules on disclosure would have the effect of frustrating national provisions, such as those on Chinese Walls, without offering a viable alternative.

### *VIII.1.2. UCITS.*

Undertakings for collective investment in transferable securities (UCITS) can be defined as specially constituted investment vehicles whose purpose is that of gathering investors' assets and invest them in a diversified pool[28] of which each investor is entitled to units of an amount proportional to her investment.

They are increasingly used by retail investors which benefit from the possibility of buying exposure to a diversified basket of assets, managed by professionals. The collective management should also ensure the benefits of economies of scale, and investors have the possibility to sell their participation in the scheme back to the open market, thereby realising their investment when they want[29].

[26] European Commission (2008a), pp. 3-4.
[27] European Commission (2007b), p. 68.
[28] Commission (2006).
[29] BME (2007), p. 50.

Units of UCITS can be allotted to retail clients through different intermediaries: not only those who manage the scheme themselves, but also investment firms and banks in the provision of investment services. This circumstance has contributed to their wide diffusion[30] and increased perception of substitutability between these and other instruments. The latest survey conducted on behalf of the European Commission shows that, by 2005, investment funds ranked fourth in the investment portfolio of European households. Only accounting for the direct holdings of funds, the amount of investments in seven selected countries (among which Germany, France, the UK, Italy and Spain) reached 1.721 millions of euro. An amount which is comparable to that invested in bonds (1.282 millions of euro) and equity (1.173 millions of euro) by households of the same selected countries in 2005. There is little wonder in finding that the amounts invested in these instruments are so close one another: in fact, the survey highlights that investors perceive them all having the same function of long-term savings vehicles.

The substitutability, both in the perception and in the *de facto* economic function of these instruments, coupled with their wide diffusion, require the legislator to attentively regulate these instruments. It should offer investors the same level of protection (especially with respect to the possible conflicts of interest exploitation) as available for other instruments. The playing field should be levelled at the supranational level for two reasons, not lastly because the cross-border activities on UCITS are "a notable exception" in the overall panorama of primarily domestic retail finance[31].

To the extent to which MiFID applies, some potential exploitations are avoided. The ISD already included units in collective investment undertakings in the list of financial instruments. Reception, transmission and execution of orders thereon, as well as their placement, fell under the category of investment services. The provision of advice on the possible purchase of UCITS was encompassed among the ancillary services. I have already pointed out in general the benefits triggered by MiFID where it includes the provision of advice among the core service, and where it more extensively rules the conduct of business. Clearly, they also apply when instruments such as UCITS are concerned.

There is nevertheless the risk that clients are protected against conflicts exploitation to a lesser extent when they deal in these instruments. There are two reasons for this: first, the conduct of business rules are not completely tailored for the conflicts inherent to the provision of services on UCITS' units. Second, the chain which starts with the product-design and ends with its sale to investors develops through different stages and involves a number of players. Each of them enters the chain carrying own interests, possibly conflictual with those of the clients, so that the potential for exploitation expands grandly.

Across Europe, UCITS have always been organised under a number of different forms, and pursuant different rules[32]. In recognition of their importance in the marketplace, and of the

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[30] Despite the relative stagnation during the period 1999-2005, and the stock market downturn of 2001-2002, aggregate data of the 25 EU countries show that between 2000 and 2005 the investment in funds has risen by 11,81%: MBE (2007).

[31] BME (2007), p. 25 and 28: "most of the funds set-up in 2001-2004 were distributed in at least three EU member states".

[32] Nevertheless, two models can be highlighted. Under the contractual model the UCITS takes the form of a pool of securities (managed by a management company) of which investors acquire units sold through a distributor. Under the corporate model a company (which is the UCITS itself) is set up with the principal objective of investing in a portfolio of securities, and the investors acquire shares of that company: IOSCO (2006).

importance of an integrated market, the Community intervened, back in 1985, to level the applicable laws and administrative provisions. Directive 85/611/EEC[33] pursued two aims: that of "approximating the conditions of competition between undertakings" and that of "ensuring more effective and more uniform protection for unit-holders". As a result, UCITS would be able to act in different jurisdiction on the basis of their Home State's passport, and market units to the largest extent possible without investors being threatened by an un-even level of protection.

The coordination was limited to open-ended UCITS, i.e. schemes allowing unit-holders to easily realise their investment in the open market at will, being those offered to retail clients. Regulated UCITS could conduct their activities under any of the forms usually employed in Member States, safe for the need for entrusting clients' assets to a depositary[34]. The 1985 framework has been amended by Directives 2001/107/EC and 2001/108/EC[35] which, despite containing important innovation for the benefit of market integration, do not change this principle.

The management of UCITS, as well as their marketing to retail investors can be tainted by a number of conflicts of interest[36].

There can be a mismatch between the interests of the investors and those of the UCITS manager or of the brokers/dealers the manager might employ for the execution of the fund's transactions. For all these agents the interest is that of increasing the revenues. Investors are by definition exposed to unpredictable market shifts, so that their monies need not give high return when this is incompatible with the market trends. But they should nevertheless be all put at use for their benefit, in order to achieve the highest possible returns in light of the level of risk which investors have accepted. The conflicts of interest between managers and investors have different sources, and can bee exploited in a number of different ways.

In the selection of the investments and the liquidation of the units, the UCITS manager can directly or indirectly give preference to its interests over the investors ones. Its give direct precedence to its interests any time it does not truthfully represent the value at which the assets are purchased or the units are liquidated: it might buy at a lower price than stated or liquidate the investment at an higher price than that stated and divert the difference to itself. Inexact evaluation of the portfolio could also be used by self-serving managers to simply disguise their poor performance.

UCITS' managers can give indirect precedence to their interest when they serve affiliated interests with the investors' monies[37]. For example, they can purchase from affiliated parties assets

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[33] Council Directive of 20 December 1985, in O.J. L 375/3 of 31 December 1985.

[34] Clearly, the Directive only applies to funds domiciled in a Member State. In addition to this, it should be publicly offered, invested in transferable securities (and other assets after the amendments brought about by Directive 2001/108/EC), operated on the principle of risk-spreading.

[35] Directives of 21 January 2002, both amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertaking for collective investment in transferable securities (UCITS). Published in O.J.E.U. L 41/20 and L 41/35 of 13 February 2002, respectively (hereinafter: 'UCITS Directives').

[36] The contractual model (above, endnote …), entails peculiar conflicts of interest, which I shall only briefly recall. Under this model, the management company is a legal entity, separate from the UCITS. Therefore, its directors shall not only respond to the units holders, but also to their shareholders, and the interests of the two groups may well collide, since the actions taken to maximise the value of the units do not always correspond to those needed to maximise shareholders' value. Intuitively, the more the company charges for its management services, the better off its shareholders are; but unit holders are penalised thereby, insofar as they risk overpaying for the services they receive

which are overpriced, sell them at an under-price to affiliated parties, or surrender to affiliated parties some assets in exchange for wrongly-valued or illiquid ones. In these cases, the difference between the market price of the assets and the sum paid for them represents an amount of investors' monies which is not put to their benefit. *Mutatis mutandis*, selling at an under-price or exchanging liquid for illiquid assets means depriving investors of part of their investment. Alternatively managers can invest the fund's resources in companies which are clients to another company of the group: thereby they pursue the interest of such company and, indirectly, that of the group in contrast to the investors' interest if the exposure to that issuer is not coherent with the risk profile of the fund.

In the same vein, UCITS managers might purchase from affiliated parties assets which are inadequate for the UCITS' objectives: by so doing, it gives a sure amount of monies to their affiliates and exposes investors to risks which they were not willing to accept in the first place.

Managers can also act for the account of a number of UCITS at the same time. This might taint their decisions to the detriment of one of them: for example, they can place orders and decide on which account to allocate the resulting trades only after having appreciated their outcome; also, they could place orders for one UCITS' account on the knowledge of the orders executed for the other UCITS' account.

Lastly, conflicts of interest also arise where the CIS manager uses the voting rights attached to the portfolio of securities it manages. In a multifunctional financial institution (or a conglomerate) encompassing both a CIS manager arm and a corporate arm, the CIS portfolio might be invested in the shares of a company which is client of the corporate arm of the institution. The management arm might then use the voting rights attached to the portfolio it manages in a way which is beneficial to the company's other shareholders (possibly the majority shareholders), and detrimental to the shareholders it represents (minority ones) [38].

For the execution of transactions UCITS recurs to brokers/dealers. When these are affiliated, the manager could be tempted to pay them excessive commissions out of the investors' monies, or to surrender to the broker/dealer benefits deriving from the buying and selling activities which should be otherwise attributed to investors. Also, it might route the portfolio trades to affiliated entities, although they do not ensure their best execution.

Lastly, affiliated brokers/dealers might increase manager's margins or commissions by undertaking an unsuitable number of transactions[39]. Irrespectively to affiliation, brokers/dealers might front-run the activities they undertake for the UCITS, preferentially serve the UCITS which offer them the highest returns, or, when duly remunerated for this, undertake transactions in a way which is not in the best interest of the fund, in the interest of the manager, in light of its own transactions or its other affiliations.

Other conflicts arise at the point of marketing of units through the facilities of a distributor. Management companies can always align the distributors' preferences with their own, to the detriment of investors. For example, they can pay extra commissions for the distributor to preferentially and aggressively market they units, irrespectively to whether they correspond to the best interest of any given investor. Aggressive marketing increases the amount of assets managed[40]

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[37] These cases are thoughtfully considered by IOSCO (2000), pp. 4-5.

[38] See Kruithof (2005), p. 17.

[39] IOSCO (2000), pp. 55 ff.

[40] Pursuant Frankel (2007), p. 375, this also creates a cascade effect: "the more investors purchase fund shares the more other investors they are likely to bring along".

which in turn reduces the costs of managing them[41] but also – and more crucially – increase the managers' revenues. Managing company's remuneration structure is normally made increasing at the increase of the assets under management. Nevertheless, larger pools do not necessarily correspond to the units' holders best interest: "size may restrict their managers' flexibility to trade when opportunities arise"[42].

Problematically, the distribution of units is less attractive to intermediaries than the accomplishment of portfolio trades is: the former mainly benefits managers, who increase their revenues for bigger pools under management, whereas the latter give mark-ups to brokers/dealers. The practice has shown that the two activities can be performed by different entities, in which case nevertheless distributors should be accorded 'give-ups': the entity performing portfolio trades gives up some of its commissions in order to ensure that the distribution activity is sufficiently remunerative.

The collective performance of the two activities by one entity makes nevertheless good business sense. In this way, the distributor is paid through the brokerage activities. Intermediaries can bargain to obtain the mandate for the performance of both services together. Problematically from the investors' point of view, though, the distributor which also acts in the brokerage activities needs not be the best available broker for any given transaction of the UCITS[43].

Let us now consider the extent to which MiFID solves the named problems of conflicts of interest. The setting up and management of UCITS is not an investment service under MiFID. Nevertheless, banks and investment firms also play a role in the chain which starts with the setting up of UCITS and ends with the allotment of their units to retail investors. In particular, they can perform the portfolio trades as brokers/dealers for the UCITS manager, they can market UCITS units giving advice to retail clients, they can execute unit-holders' orders[44]. Moreover, they can invest their clients' individually managed portfolios in UCITS units. With all these activities they are indeed performing investment services, and MiFID applies.

When firms exclusively accomplish clients' orders with respect to UCITS' units both suitability and appropriateness tests are waived (art. 19 (6) of the L1 Directive). Such waivers are nevertheless not problematic. Units do feature the same level of non-complexity as other instruments to which identical exceptions apply. Importantly, though, recital 61 together with art. 38 of the L2 Directive make clear that units of non-harmonised funds can be treated as non-complex instruments only insofar as further conditions are fulfilled: in particular, there are frequent opportunities to dispose of them at prices which are publicly available and are evaluated by a system independent of the issuer, in particular a depositary.

The distribution of UCITS' units can be performed by intermediaries on behalf of UCITS' managers also as a placement service: the investment firm simply informs the clients about the offer, and collects their applications which are then passed to managers, without the application of the suitability rule and the like. For this service, the intermediaries receive commissions from the part of the UCITS manager. As it happens for any other financial instrument, intermediaries might place with preference those for which they are paid the most. As for any other financial instruments, then, such inducements should pass the test of art. 26 of the L2 Directive, and in

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41 Pursuant Frankel (2007), p. 379, manager who do not pass these savings on investors beach their fiduciary duties in that they benefit from other people's money (misappropriation of economies of scale).

42 Frankel (2007), p. 379.

43 Frankel (2007), p. 378.

44 See CESR (2007e), p. 5.

particular do not impair the duty to act in the clients' best interest. Following CESR, for the placement of UCITS' units the test translates into the verification of whether the commissions are 'disproportionate'[45]. The evaluation of what can be deemed proportionate is nevertheless rendered more difficult in light of what said above about the low profitability of the service of mere unit placement.

As the practice has shown, when the placement and the brokerage for UCITS' portfolios are performed by different entities, no placement would take place if the broker did not surrender a relevant part of its commissions in favour of the placing entity, although this latter performs activities of limited complexity for the benefit of UCITS' managers.

When intermediaries cumulatively perform brokerage and distribution, they have the incentive to place units aggressively, by advising client to do so: not only because of the distribution fees, but also – and most importantly – as an intense placement ensures brokerage activities on larger pools of assets and hence, higher returns. The same happens when intermediaries exclusively act as distributors, if they have a commission rebate agreements with the broker. In both cases, if the placement is ensured by the provision of advice to retail clients, the suitability rule should ensure that it takes place accordingly to the investors' interest, and not beyond it.

When providing portfolio management, firms could have the interest of placing it in units of the UCITS they market. This happens to be the case if the UCITS is managed by a company of the group, or if the intermediary receives money or other benefits for this purpose. The rules on disclosure of conflicts of interests deriving from group links, and those on disclosure of inducements apply to such case as well.

Concerning inducements, though, it is unclear how they can be disclosed to clients before the service of portfolio management is performed: such service is carried out on the basis of a discretionary power, which allows firm to decide investment strategies independently from the client, and also in the course of the performance. If this is true, though, firms do not know beforehand (or at least are legally not presumed to know) whether they will be investing in units for which they receive inducements, and the amounts thereof. This interpretation seems backed by art. art. 30 (3) lett. d) of the L2 Directive: before the provision of portfolio management firms have indeed to describe the types of financial instruments which can be included in the portfolio; nevertheless, a generic indication of envisaged investment in UCITS's units seems to be sufficient for this purpose[46].

Also the suitability rule applies. The way it is formulated for portfolio managements ("a transaction might also be unsuitable if it would result in an unsuitable portfolio", recital 57 of the L2 Directive) prevents an over-investment of individual portfolios in all instruments, units included.

Although the investment of a reasonable part of the clients' money in such instruments can be coherent with their risk profile and return expectations, if other instruments exist which offer the same degree of suitability, the intermediary is acting in a way which is more costly for the clients. In fact, this type of investment allows intermediaries to reap double fees: those for the individual management and those for the units' placement. Even if these latter come out of the UCITS manager's pocket in the first place, investors often end up paying for them, and disburse

[45] CESR (2006), p. 9.

[46] Also CESR (2006), pp. 10-11, seems doubtful as to the possibility that the amounts paid by the CIS manager can be disclosed to clients as art. 26 (b) (i) would require.

twice for a service which could simply be obtained with one transaction (the subscription of units) and one type of expenses (the management fees)[47].

Under MiFID, firms should bring to the attention of clients the multiplication of costs. Art. 33 of the L2 Directive entitles them to receive the information on costs and associated charges of the service, and in particular on the total price thereof. Nevertheless, only the commissions charged by the firm shall be itemised separately, so that those due for the UCITS' management might well remain obscure. Moreover, it is unclear whether and how the prospectus, which normally accompanies the sale of units and contains further information as to the part of costs due for the collective investment[48], can be disclosed to clients, as it would be in case of a direct investment in those units. As mentioned before, in the provision of portfolio management the decision to invest in UCITS's units can be independently made by the intermediary in the course of the provision of the service, without the client being constantly updated on such decision and, hence, given the piece of information which would follow.

By all token, whether the problem of intermediaries investing individual portfolio in collective funds can be solved simply by requiring the intermediaries to disclose all the fees they charge to investors is questionable[49]. Hence, one could argue that intermediaries should never invest individual portfolios in units which they can also directly place. Nevertheless, this is too restrictive as a solution, since units in individual portfolios are managed directly by the intermediary, which could serve the best interest of the client, by putting to use its experience and knowledge of her comprehensive investment situation.

CESR's opinion is that such situation is likely to be unlawful; the Committee would nevertheless treat the case differently, were it found that the intermediary pays the commissions it receives from the UCITS' manager back to the investor. It also (exceptionally) allows firms to prove that the requirements of art. 26 of the L2 Directive on inducements are fulfilled and, hence, that the client's interest is duly served.

Next to the described deficiencies of the regulation, the level of protection set for UCITS direct investments is uneven (higher) and that set for UCITS investments undertaken through portfolio management. For direct investments, next to the simplified prospectus of Directive 2001/107/EC, which spells out the costs associated to the collective investment, intermediaries should also provide information about the costs of its marketing. In fact, under art. 34 of the L2 Directive the provision of such prospectus is sufficient for firms to be held compliant with their duty to disclose the costs and associated charges of the investments (as art. 19 (4) fourth indent of the L1 Directive requires), but only those *related to the UCITS itself* (art. 34 (2)). It does not give sufficient information as to the costs clients bear for the placement of the units, which should be separately communicated, as recital 55 of the L2 Directive confirms.

Lastly, MiFID's seem insufficient to address another case of conflicts' exploitation. When intermediaries act as brokers for UCITS' managers, they are considered to deal with eligible counterparties (art. 24 (2) of the L1 Directive). For these transactions, the safeguards of arts 19, 21

[47] If such expenses do not end up being paid by clients, but are paid by the manager to the intermediary, the abovementioned problem of inducements arises.

[48] See in particular art. 33 and Annex I Schedule C to Directive 2001/107/EC: the economic information of the simplified prospectus should mention entry and exits commissions, as well as other possible expenses or fees, distinguishing between those to be paid by the unit-holder and those to be paid out of the unit trust's/common fund's or the investment company's assets.

[49] Indeed, for UCITS' managers a different approach is used: see below in this chapter.

and 22 (1) of the L1 Directive shall not apply. Therefore, managers are not entitled to information about the execution venues, costs and associated charges of the activities; intermediaries are not required to: ensure that the execution for eligible counterparties takes place on the most favourable terms for eligible counterparties; transparently present the considerations which have led to a particular execution; ensure the prompt, fair and expeditious execution of orders. True is that eligible counterparties feature sufficient experience as to understand the terms of the transactions and can contract for the level of protection they require, as well as control its respect. For these reasons, UCITS' managers willing to serve the unit-holders' interest are on the footing for doing so. But if their interests are aligned with those of the broker, and diverge from those of the investors, these latter are deprived of a layer of protection. The one which would be ensured if the broker had to execute the orders in compliance with pre-determined procedures of which track is kept.

Even where the activities undertaken by banks and investment firms can take place in respect of the clients' interests, the final result of the investment, and in particular the possibility that clients are exploited, grandly depends upon the management of UCITS, which is not regulated under MiFID.

The first UCITS regulation of 1985 mainly aimed at laying down rules which would allow collective investment undertakings authorised in one Member State to freely operate across Europe. For this purpose, after the authorisation released by the Home State to undertakings having the requirements listed in the Directive, firms would benefit from a community passport. The structure and operations of passported firms had to give some assurances as to the protection of investors. In particular, the involvement of an independent entity in the management chain was given high importance, also in consideration of the fact that investors cannot give instructions to the manager on a investment-by-investment case and loose complete control over how their money is employed. This was a first response to the problem of manager's self-serving behaviours when holding clients' funds, redeeming the units, allocating transactions. Other rules on capital adequacy, and on the ways in which the fund's monies could be employed, mainly aimed at ensuring stability of the intermediaries and a sound risk-spreading approach to management..

Only several years later, with Directive 2001/107/EC, the Community has further intervened: the purpose of this Directive was that of regulating companies which manage collective investment undertakings to a larger extent (see recital 2)[50]. It ensures their ability to operate cross-border with the passport of the Home State to be released upon verification that the conditions for taking up and operating the business are fulfilled (initial capital requirements, repute and skills of relevant persons, control over qualifying holdings, adequate organisational structures – arts. 5 and following). For the purpose of a sound and safe integrated market it also more closely evaluates the problem of conflicts of interest's exploitation.

[50] In the meanwhile, the Commission has sought this opportunity to loosen up some of the previous constraints. For example it has allowed UCITS' managers to also provide the service of individual portfolio management, as well as some non core activities linked to the main business (such as investment advice, safekeeping and administration of UCITS: recital 9 and art. 5 (3)). In so doing, it was aware of the possible multiplication of conflicts of interest and the risk of arbitrage. These circumstances have not been neglected: art. 5f (2) prohibits the manager who perform both collective and individual management to invest all or part of the clients' portfolios in the units it manages, unless given a prior general authorisation; art. 5 (4) makes the ISD's conduct of business rules applicable to the managers who provide those services, as if they were provided by investment firms.

Clients' interests and the risk of their exploitation are taken into consideration under the operating conditions of art. 5f. The Home Member State shall require that such companies: have "internal controls mechanisms including, in particular, rules for personal transactions by its employees or for the holding or management of investments in financial instruments". Such rules should further ensure that assets "are invested according to the fund rules or the instruments of incorporation and the legal provisions in force" (lett. a). The organisation of the firm should minimise the risk of "clients' interests being prejudiced by conflicts of interest between the company and its clients, between one of its clients and another" (lett. b).

The Directive does not contain harmonised conduct of business rules, but only requires each Member State to draw up rules of conduct ensuring at least that the firm acts honestly and fairly and conducts its activities in the best interest of the UCITS; acts with due skill, care and diligence; tries to avoid conflicts of interests and, should it be unavoidable, ensures that UCITS are fairly treated (art. 5h lett. d).

A part the obvious consideration that these provisions can hardly be said to bring about any harmonisation and level-playing field at all, as it was under the ISD, they are insufficient from different points of view: they do not clearly identify the cases in which States' measures against conflicts exploitation are needed, and the measures which should be taken.

This holds true although some of the conflicts faced by UCITS' managers are broadly the same as those faced by intermediaries in the provision of investment services, and similar measures could apply[51].

For example, imagine the case of a company who manages two UCITS, and only allots the transactions undertaken to the account of one or the other after having appreciated their result. The directive requires internal control systems to verify that monies are invested according to the fund rules or the instruments of incorporation. If these latter lack all details about the allotment criteria among different accounts, the internal control can serve little use in solving the inherent conflict of interest. True is that such controls should also verify compliance with the legal provisions in force, and that States have to enact rules ensuring fairness of treatment among UCITS. Nevertheless, the qualification of fairness is completely left to national conduct of business rules, and the minimum harmonisation approach does not ensure that all jurisdiction gives due consideration of that specific case of unfairness.

The requirements for UCITS' fair treatment does not address the problems arising when only one undertaking is managed by a company, and also does not ensure unit-holders' fair treatment: the circumstance that the investment of an individual holder is not sold promptly or at a correct value, for example, does not per se undermine the unfair treatment of the UCITS. Individual holders' interests should be taken into consideration when setting up the structure and organisation of the undertaking (art. 5f lett. b), and are not explicitly mentioned as interests which the conduct of business rules should protect (safe for art. 5h lett. e, which generally refers to the investors' best interest).

While the cases of churning can be addressed by the rules putting the clients best interest in the foreground, rules which would prevent insider dealing are difficult to apply: for the purpose

[51] This is not to say that the solutions adopted for the provision of investment services, and in particular for the service of individual portfolio management could copied out for collective managements. Some tools, such that of the case-by-case authorisation, or of the information and consent mechanism for the commissions paid by the manager to the UCITS' broker would indeed be inapplicable. See also Annunziata (2002), p. 122.

of art. 1 MAD, an insider is a person charged with the *execution* of orders concerning financial instruments. Managers – as investment firms in the provision of investment services – are not always, strictly speaking, executing orders. Nevertheless, they can act on the knowledge of such orders, undertaking activities which could entail a market shift or impact otherwise on clients' interests.

MiFID is aware of this difficulty for investment firms and avoids that these actions go uncensored with the provision of art. 47 (3) of the L1 Directive: "An investment firm shall not misuse information relating to pending client orders…". Conversely, under the UCITS Directive, the protection of investors from these behaviours depends on the more general test of whether managers have acted putting their interest before that of unit-holders.

The directive does not contain rules on how the broker executing the transactions for the portfolio should be selected and, in particular, the manager is under no obligation to ensure the choice of the one which offers the best execution. Nevertheless, such choice is crucial for the interest of clients and – as pointed out above – can be guided by other (self-serving) considerations from the part of the manager.

True is that the control exercised over managers' activities by independent third parties can constrain the choices made to exclusively serve the managers' own interests. The depositary should, to this end, "ensure that the sale, issue, re-purchase, redemption and cancellation of units … are carried out in accordance with the law and with the instruments of incorporation", that the consideration for transactions is remitted to the UCITS' assets within the usual time limits, that the income is applied in accordance with the law and instruments of incorporation (art. 14 (3)).

Nevertheless, this does not per se ensure uniform understanding as to the value at which the transactions can take place, especially with related parties, and neither does the rule which requires an auditor to independently and periodically value the units and ensure that the assets are invested in accordance with the law or the instrument of incorporation's rules (art. 14 (5))[52].

Hence, exclusively seen from the supranational point of view, the potentials for conflicts' exploitation when clients are offered UCITS' units are by far more acute then when they are offered other instruments, even where banks and investment firms exactly comply to what is required from them in the course of the provision of investment services[53].

This is not to say that individual States did not enact specific provisions[54] to address the cases described above. The French regulation stresses the need for Chinese walls to separate possibly conflictual functions undertaken by the managers; the English regulation counts on

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[52] Annunziata (2002), 121, advocates the need for clear conduct of business rules which the independent body (and in particular the depositary) would be called to enforce. Too strict rules on UCITS, such as pre-approval of products, though, would put the asset management sector at a competitive disadvantage: European Commission (2008a) p. 3.

[53] The Directive also fails to apply MiFID's rules to UCITS manager who directly sell the units to the public, as any investment firm or bank could do.

[54] Moreover, at the level of individual countries, other problematic situations have been highlighted: in Italy, for example, the distribution channel of UCITS does not appear to suit the clients' best interest. Units are sold almost uniquely by banks and intermediaries included in banking groups. Their distribution therefore competes with that of other instruments, which are less costly in terms of (managing) efforts the intermediary should undertake after the point of sale. For the placement of these instruments, intermediaries are often accorded high commissions and fees, which are merely used to ensure the diffusion of the product, and do not add to its quality: Gruppo di lavoro (2008) p. 30

independent trustees to closely review of fees and commissions charged; the German regulation avoids conflicts of interest between the investment company and the depositary by means of organisation; the Italian regulation has extended some of the MiFID's conduct of business rules to fund managers as well. Back in 2005, law 262[55] already contained innovative (protective) provisions. With the purpose of controlling conflicts of interests, art. 9 limited the possibility to invest collectively-managed funds[56] in financial products issued or placed by companies belonging to the same group as the manager, or belonging to other groups which entertain financing relationships with the manager's group. It also limited the possibility to obtain brokerage services from intermediaries belonging to the same group: only 60% of the total value of purchases and sales executed could be channelled to these brokers. Below this threshold, managers can use affiliated brokers, but nevertheless have to disclose to their clients the percentage of trades accomplished through this means and, above 30%, they shall give account of the (quality and efficiency) advantages these brokers ensure[57].

Nevertheless, in case of cross-border provision of services trough branches[58], the lack of supranational rules leaves clients' protection against conflicts of interest's exploitation in the hands of a number of exclusively national provisions which are often difficult to coordinate one with another.

When the managing company sets up branches, Host States are entitled to indicate the conditions for operations, including the rules mentioned in art. 44 of Directive 85/611[59], under which in the interest of the general good the business must be carried out (art. 6a (4) of Directive 2001/107/EC). For sure, this means that Host State's rules on the marketing of units – except those on the prospectus, which are harmonised at the EU level – apply. In fact, art. 44 obliges UCITS which market units in another Member State to comply with the laws in force in that State which do not fall within the field governed by the Directive.

Host States' conduct of business rules explicitly devised for conflicts of interest also apply (art. 5f (1) lett. b of the 2001 Directive), and they take precedence over the rules on the company's structure and organisation enacted (by Home States) for the same purpose. It is also easy to argue that other Host States' conduct of business rules apply (such as those on best execution of the orders, irrespectively to whether managers accomplish the orders themselves or transmit them to a broker, as it is under the Consob's 16190 Regulation, arts 68 and 70): art. 6a (4) refers to art. 44 only by way of exemplification, and does not appear to exhaust thereby the range of Host States' applicable rules. In addition, although Directive 2001/107/EC lays down some conduct of business

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[55] Of 28 December 2005, O.J. n. 301 of 28 December 2005..

[56] But the provisions also apply to the investment of individually-managed funds, as well as insurance products.

[57] All in all, the level of transparency enacted through national measures is fairly high for these instruments. Nevertheless, as emphasised in a number of international fora (last but not least, European Commission (2008)), their ability to prevail over other more opaque instruments, or to trigger a race to the top in terms of transparency, is hampered by the fact that they are mainly channelled though banks, which give preference to other, less regulated and more remunerative instruments – such as structured products and bank bonds. This situation is likely to remain, at least until other forms of distribution (such as direct distribution though the internet) take the upper hand.

[58] For the provision of services without establishment there seem to be far lesser concerns: apparently, the host state's competence is limited to the rules of conduct which pertain to the provision of individual portfolio managements, which are currently harmonised under MiFID: art. 6b (3), second subparagraph of the 2001 Directive.

[59] This article has not been amended with the 2001 reform.

principles (fair treatment, protection of clients' interests), these do not appear to be sufficiently detailed to argue that no scope is left for States' interventions on the matter.

Nevertheless, it is not clear what happens with the rules stipulating how the assets on which the fund is invested should be valued, or how the trades should be allotted among different UCITS' accounts. They might be set out either in the laws of the Home State or in the fund's regulation, but they indeed impact on the fair treatment and protection of the clients' interests, which is a Host State competence. This problem is not negligible, insofar as most of the protection provided for by the Directives depends upon the depositary being able to ensure compliance with those rules (art. 7 of the 1985 Directive).

The Commission is currently hosting works for the amendment of this framework[60]; nevertheless, such difficulties are not under review. Art. 6a is only slightly reworded in art. 16 of the envisaged new directive. The only difference lays with the fact that, under the new regulation, managers willing to market funds abroad shall also transmit to the Host State the fund's rules or its instruments of incorporation (art. 88 of the envisaged new directive). Since the marketing can start immediately afterwards, and the Host State cannot request any additional documents, certificates or information, it is legitimate to argue that these rules take precedence over the Host States' rules devised to protect investors, if compliant with the Home State's regulation. Hence, the 'hierarchy' of laws is made clearer, but the full set of problems concerning clients' protection is not addressed[61].

### VIII.2. New Technologies: Provision of Services over the Internet. Product and means arbitrage.

The other important financial markets' trend is the development of new technologies. Ecommerce has recently spread among retail clients, giving them unconstrained access to the widest range of operators and services.

As of the benefits of this trend, it ensures the deepest integration of the European market, and could represent the apex of cross-border transactions; hence, it should be encouraged. The most recent surveys show that, whereas the internet is increasingly used by investors, the rate at which it allows for the cross-border provision of services is negligible[62].

Its twofold drawbacks should not be overlooked. Internet transactions allow for the circulation of products and services irrespectively to the fact that they are harmonised at the European level and sold by authorised entities falling under common protective standards. For example, collective investment undertakings which are not included in the scope of the UCITS Directive, and are therefore only subject to a local regulation, conferring them an exclusively

[60] European Commission (2008c).

[61] In addition to this, art. 7 on the depositary's duties is copied out in art. 19, and the same goes for the general conduct of business rules of art. 5h (to be included in art. 14 of the new directive).

[62] The European Commissions (2005), pp. 18 ff., shows that in the banking sector, 65% of operators used distance marketing, but the rate of cross-border activities performed through this means is statistically insignificant (well below 1% of the activities and in some cases less than 0,1% thereof).

national authorisation, could reach investors throughout Europe[63]. The counterargument that consumers can be benefited from a wider choice hast little bite, since products "might not be comparable and could have completely different risks characteristics"[64].

If not regulated accurately, Internet transactions could also contradict the principle of irrelevance of means[65], following which identical products and services should grant investors the same degree of protection, irrespectively to the means through which they are circulated. Such a principle ensures that markets are safe and sound in general and avoids that intermediaries elude their obligations simply by arbitraging among different technological options[66].

None of the drawbacks are fully addressed by the recent Directives 2000/31/EC[67] and 2002/65/EC[68], read in conjunctions with MiFID. The former aims at creating a legal framework for ensuring the free movement of information society services that is, on-line economic activities included the provision of investment services over the internet (recital 18 together with recital 11), without prejudice to the ISD, currently MiFID, which is considered "fully applicable" (recital 11).

The latter approximates the national regulations concerning distance marketing of consumer financial services that is, the conclusion without simultaneous presence of the supplier and the consumer, of contracts relating to any service of a banking, credit, insurance, personal pension, investment or payment nature (arts 1 and 2 lett. a, b). Its scope is wider than the one of the ecommerce directive, and encompasses this latter, since all internet transactions also fall under the category of distance marketing[69]. Pursuant recital 27 of the ecommerce directive, the two Directives contribute to the creation of a legal framework for the on-line provision of financial services, leaving open the possibility of future harmonisation efforts (such as MiFID)[70].

Concerning the first drawback, if unregulated products are circulated at a distance and through the internet, there risks to be no real safeguard. The ecommerce directive is more concerned with the problem of ensuring that national legal systems are such as to allow for the conclusion of contracts by electronic means and that rules are in place to regulate the liability of the provider of the technological services[71]. As of information duties, which would represent a

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[63] As Biancheri (2002), p. 146, puts it: "activities which are not subject in all jurisdictions to previous authorisation or control could be freely provided within the European Union on the sole basis of the existing (or non-existing) regulation of the country of origin".

[64] Biancheri (2002), p. 150.

[65] Biancheri (2002), p. 141.

[66] The threats posed to firms by the diffusion of such technologies should not be underestimated: if they are not promptly or clearly regulated, the legal risk increases. The same goes for operational risks insofar as there is "no homogeneity in the regulatory and supervisory powers of national authorities": Biancheri (2002), pp. 150-151.

[67] Directive of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market, published in O.J.E.C. L 178/1 of 17 July 2000 (hereinafter: 'ecommerce directive').

[68] Directive of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC, published in O.J.E.C. L 271/16 of 9 October 2002 (hereinafter: 'distance marketing directive)'.

[69] The distance marketing directive shall therefore be applied in conformity with the ecommerce directive, as recital 6 of Directive 2002/65 states.

[70] The application of Directive 93/13/EEC on unfair terms in consumer contracts is safeguarded, but that on distance contracts shall not apply (see also recitals 11 of the ecommerce directive and recital 10 of the distance marketing directive).

[71] For example when they store or intermediate in the transmission of information (arts 12 and 14).

minimum safeguard for clients dealing in un-regulated product, it limitedly requires firms to provide information about the technical steps to follow for the conclusion of contracts, the contractual terms and general conditions and the like (see for example art. 10), and states the applicability of the mandatory contractual rules of the consumer's habitual residence (recital 55)[72]. Thereby, it adds very little to what would already be applicable under national contract law and the Rome Convention.

A more detailed regulation for the protection of consumers can be found in the distance marketing directive, whose scope is nevertheless almost exclusively restricted to the issue of pre-contractual information. Before the consumer is bound by any agreement, the supplier shall communicate information about itself (its identity, its home state, the identity of its representative), the contract (the duration, the right of withdrawal and other rights such as that to redress, the applicable law – without prejudice for the Rome Convention of this matter) and the service. The information about the service more closely resembles that of MiFID, in that it relates to its main characteristics, the total price – including all related fees, charges and expenses – the special risks, if any (art. 3 (1) (2)). Such information can also be provided after the conclusion of the contract – as it happens under MiFID – if the service was concluded at the request of the consumer, and the means of distance communication employed does not allow for anticipated provision of information (art. 5 (2)).

All in all, this is only a first layer of protection, which does not contradict the need for an higher pace of regulatory convergence among Member States in areas left so far untouched.

The second drawback concerns the possibility that the same service or product would be subject to different rules, depending upon the means used for its marketing. This is not to say that the regulation should not give account to the peculiarities of the means deployed, also with the view of exploiting the efficiencies they allow for[73].

In this vein, forms of coordination between distance and non-distance marketing situations are contained in MiFID. Art. 29 of the L2 Directive rivets that some information can be communicated to the client after starting to provide the service in case the use of a means of distance communication is deployed. Among this information, in addition to that already mentioned by Directive 2002/65, the named article also includes the description of the conflicts of interest policy.

Despite the necessity for some wavers, what should be avoided is that different means are used to circumvent the obligations otherwise applicable, without any objective justification thereto.

For example, the distance marketing directive should have made clear that only orders on non-complex instruments can be accomplished when the means of distance communication employed does not allow for any information exchange before the provision of services: otherwise,

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[72] Biancheri (2002), p. 145, defines it a horizontal directive, which should be complemented by other regulations. The Author also notices (pp. 146-7) a mismatch between this directive and other sectoral ones, especially insofar as the former entrusts the home state of rule-making and supervisions. In particular, under the ISD, this created a problem as to the identification of the applicable national conduct of business rules.

[73] To be more precise: the regulation should take into consideration the peculiarity of the means and also the fact that through the same means different products can be circulated. It should therefore account for these additional differences as well. As it was noticed, not taking account of products' specificities as well would result in "investor detriment through the stifling of innovation and a reduction in product diversity": European Commission (2008a), p. 5

the Directive would disregards MiFID's rules on adequateness, following which the intermediary who executes orders on complex instruments shall gain information about the client's profile and compare the envisaged investment to it, in order to warn her in case it should seem inadequate.

In addition to this, internet distribution should stringently comply with the suitability rule (which is not derogated for these transactions), and the advice given over the internet should be easily traceable. The distance marketing directive would be the occasion for setting common standards to this end: this is not to say that market-led solutions cannot develop in the future; up to now, they have failed to appear[74]. In addition, solutions brought about by a directive would ensure equal treatment between on and off-line transactions, since these latter are already regulated in details by MiFID.

On the other hand, there seems to be no good reason why MiFID does not require, also for off-line transactions, the provision of some of the information required by the distance marketing directive: the information on the rights to terminate the contract early, on the contractual clauses and law applicable, on the competent court and on the existence of redress mechanisms (art. 3 (1) 3) and 4)).

Some responsibilities for ensuring an equal treatment lays with Member States as well. They should ensure that all measures at disposal of clients in case of breach of the information duties embedded in the distance marketing directive are mirrored by identical measures at their disposal when the same (or similar) duties are breached in off-line transactions.

Indeed, both the distance marketing directive and MiFID contain vague provisions on this point: States shall provide for appropriate sanctions in the event of the supplier's failure to comply with the national provision adopted pursuant …. [the] directive" (art. 11 of the distance marketing directive, which explicitly mentions the cancellation of the contract), whereas they have to ensure that "appropriate administrative measures can be taken, or administrative sanctions can be imposed" (art. 51 of the L1 Directive). As concerning investors, States should only encourage the setting-up of complaints and redress procedures for out-of-court settlement (art. 53 of the L1 Directive).

**Conclusions.**

This Chapter has enquired upon the level of investors' protection against conflicts of interest exploitation in light of two main trends in financial markets. The development of new products, increasingly at disposal of retail clients is the first of them.

In general, insurance products feature a low degree of transparency, especially in terms of remuneration structure, and the intermediary's duty to evaluate products' appropriateness is considerably watered down (as compared to what required under MiFID). As far as unit-linked insurances are concerned, their investment component risks remaining disguised, to the detriment of the client's ability to take informed and aware investment decisions. The investment in UCITS brings an additional actor into play (the UCITS' manager), which can align the intermediary's interests to its own, to the detriment of the client' best interest.

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[74] European Commission (2008a), p. 24.

The distribution of UCITS' units also triggers concerns. They multiply the occasions for exploitation which MiFID's provisions – devised to cover in general all financial instruments – have not considered.

The chain which starts with the product-design and ends with its sale to investors develops through different stages and involves a number of players. Each of them enters the chain carrying own interests, possibly conflictual with those of the clients, so that the number of interests potentially in conflict with those of the clients increases. On this respect, the UCITS directives do not embed the necessary rules against managers' self-serving behaviours.

True is that national regulations have supplemented the voids of the European rules, so that these instruments feature a fairly high level of transparency. Nevertheless, their ability to prevail over other more opaque instruments, or to trigger a race to the top in terms of transparency, is hampered by the fact that they are mainly channelled though banks, which give preference to other, less regulated and more remunerative instruments – such as structured products and bank bonds. This situation is likely to remain, at least until other forms of distribution (such as direct distribution though the internet) take the upper hand.

The second trend analysed in the Chapter is the development of means of distance marketing of financial instruments and products.

On this respected, I noticed that – unless otherwise necessary or justifiable in light of the peculiar features of these means – the regulation should avoid that they are used by intermediaries to circumvent the application of protective rules.

This recent trend also creates the case for a faster pace in the work of approximating applicable rules for products which currently do not ensure a minimum level of investors' protection across the EU. Indeed, these techniques allow for cross-border marketing of all types of products, irrespectively to the passport mechanism and to whether their national regulation (if any) is sufficient to ensure protection against exploitations.

# Chapter IX

## Conclusions.

This work has focused on the problem of retail investors protection against intermediaries' misbehaviours – and in particulars conflicts of interest's exploitation – in the provision of investment services. The analysis of MiFID's responses to this problem has been at the heart of the thesis. My aim was that of evaluating the rules devised by the Directive from a cost-efficient point of view.

Chapter I has identified the sources of the problem addressed, and the tools which can be deployed against it. It has given a roadmap as to what I aimed at considering in this cost-efficient evaluation, and is therefore worth it briefly summarising it here.

Preliminarily, I have given some insight on the role of financial markets, and the relation between investors' confidence and market efficiency. I have put the former in the foreground as a natural consequence of the fact that the core of the work considers investors protection, and in particular of the protection of those investors who need it the most (the retail ones). Nevertheless, causes and consequences are difficult to separate, and MiFID is a multifaceted regulation which takes both into consideration and necessarily makes some compromised choices.

The focus on retail investors has triggered the analysis of the role of financial institutions, which a scholar defined 'protective gatekeepers': their intermediation role is crucial for the participation of investors to the market. They put together the resources of a number of clients, and transfer them to their most efficient use, as they can judge thanks to their superior evaluation models. Not only more transactions, but also more efficient ones are made possible. In fact, at least in theory, intermediaries apply for investors their ability to evaluate investment opportunities.

Nevertheless, such gatekeepers can also put investors protection at stake. The case of incompetent intermediaries aside, most (if not all) improper performances of services are due to a voluntary misbehaviours of firms vis-à-vis their clients. The existence of conflicts between the interests of the firms and those of their clients and the intermediaries' desire to exploit them lay at the heart of these misbehaviours.

To explain this, Chapter I has analysed the economic theories on the market players, on their relationship, their contracts and their biases. I have in particular described the principal-agent set-up and the threats it poses in terms of conflicts of interest's exploitation.

In my description of such a set-up, I have given preference to the points made by the behavioural economics: unlike the finding of the classic economic theory, it allows to explain why players (and principals in particular) are on the footing of neither judging the actions undertaken by their agents, nor obtaining and verifying their proper behaviour simply by bargaining for it. Behavioural economics acquaints the existence of cognitive biases which render the principals' exploitation easier to undertake.

It has followed a description of the types of contracts which can be entered into under the principal-agent set-up, namely incomplete contracts which can only be enforced under very strict conditions (for example the existence of reputational mechanisms). For this purpose, I have drawn from the part of the economic literature which allows for the incompleteness of contracts even where only one party lacks information.

In the following part, I have explained how these findings apply to financial intermediation to further expand on the matter of its threats. In the provision of investment services, intermediaries and their clients act as agent and principals (respectively) of a principal-agent set-up. Nevertheless, this agency situation is much more problematic from the point of view of the protection of principals.

As principals, investors are affected by biases similar to those identified by the behavioural economics and more deeply enquired upon by the studies of behavioural finance. Although some thematic works have seized to argue for investors' rationality, I held that their results cannot be conclusive. As agents, intermediaries are more risk-averse than their principal. Therefore, the structure of the remuneration the former are paid can play little role in controlling their incentives to exploitation. Unlike other agents, intermediaries always serve different clients which gives rise to a common-agency set-up. Under this setting, the agent acts for two principals (which can stand on the same or on different sides of the market): when their interests collide and the intermediary has incentives to give preference to the interest of one among them, the problem of exploitation becomes more acute.

The intermediaries-clients relationship also differs from other principal-agent set-ups in that the information asymmetries and the occasions and motives for exploitation are more acute. To address these points I have spent some words on the (the opacity of the) goods which are exchanged on financial markets, on the operativity of the intermediaries and on the structure of the industry.

The analysis of the market for intermediation services has been useful to explain why the incompleteness of the contracts between firms and clients cannot be completed by some form of endogenous enforcement. I have in particular stressed the high level of concentration of this market. Even allowing for the opposite conclusion, i.e. that a sufficient level of competition can be detected in this industry, a number of studies has shown that intermediaries lack the incentives to use the levels which would make competition work as an external control over firms' self-serving behaviours.

Since my main focus is a set of European regulations, after having briefly presented the debate on the rationale for regulation and on the benefits of having a supranational (as against national) regulation, the last part of Chapter I discussed the tools for a cost-efficient evaluation.

First, the regulation should identify the situation it addresses that is, choose the market failures relevant to the regulated situation, having regard to the player, their contracts, and the goods circulated with the transactions. A regulation on the provision of investment services should in particular identify the features of the average investor, be it rationality coupled with a mere information asymmetry, or cognitive biases. I have argued that the cognitive biases hypothesis more accurately describes the market, but in lack of conclusive remarks rational investors asymmetrically informed could also be the addressees of the regulation. Importantly though, the choice has to be consistently retained throughout the regulation.

The interrelation between investor protection and market efficiency also requires the regulator to decide whether protection should equal avoidance of actual losses, or something beyond that, and choose the dominant approach when the unconditional protection of clients might contradict market efficiency.

The regulation should also select its tools. I have highlighted the benefits of a 'libertarian paternalistic' approach. It can accommodate for the existence of different players on the market and for the biases and limits of the regulator as well.

Its paternalistic component accounts for the fact that some players on the market err in their choices and it is beneficial to put those players in the condition to pursue their best interest. Depending upon the biases which lead to such errors, the regulation can set default rules (for example if agents tend to stick to the status quo but the probability is high that the initial 'endowment' is detrimental and should be changed), mandate the provision of information (if information asymmetry accounts for the most prominent failure), introduce advice duties (if agents do not know what they need), complete incomplete contracts (if monitoring is not effective and enforcement is hampered).

The choice among the aforementioned possibilities determines the degree to which the paternalism is also libertarian: the more parties retain the power to take decisions on their own, the more libertarian it is. The more the regulation is inclusive, the more opt-out possibilities shall be accorded. This flexibility adds to the cost-efficiency of the regulation since it accounts for the fact that not all players feature the same biases, and some are indeed able to maximise their benefits so that a choice paternalistically imposed to them is wealth-reducing. It also accounts for the fact that the regulator itself might well suffer from information asymmetries and biases, so that it cannot confidently identify what is better for the economic agents.

The libertarian paternalism does not impede – where the regulator's sophistication and the distribution of rational agents in the market allow for it – to enact a fully paternalistic approach for some players, and a fully libertarian approach for other players. The result shall nevertheless be that the benefits for those who would otherwise err (net of the implementation costs) outweigh the costs for those who would not need be protected.

Implementation costs are also important. For any increasing level of clients protection, the regulation should also have regard to the costs imposed on intermediaries. From the investors' point of view, the more rights they are conferred – without that slowing down or hampering transactions – the 'better' the regulation is; nevertheless, the same cannot be held from a cost-efficient point of view. A regulation which accords overprotection to some investors does not add anything to their protection, while clearly adding to the costs of compliance.

Reducing these costs should not be seen as the aim of a 'neat' regulator, but also as a true interest of the industry as well as of the investors. These latter are directly damaged insofar as the intermediaries: shift the costs on them, by increasing the costs for the provision of the services; refuse to serve the marginal investor, the one which despite obliging firms to comply with the full set of rules, offers limited revenues.

Lastly, and this touches upon the coordination problem which each new regulation creates, it should be neither redundant nor contradictory with respect of the obligations laid down by other pieces of regulation. In these cases, a clear dead-cost for compliance can be detected.

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Against this backdrop, the Chapters altogether make the following points.

Overall, MiFID represents a step forward as compared to its forerunner, the ISD (Chapter II). At first sight, it addresses the market failures relevant to the intermediary-client relationship.

Having regard to the complexity of financial markets, it considers both agency and common-agency set-ups; it identifies the sources of the intermediary-client irreconcilable interests and the way clients can be exploited. For this purpose, it does not only spell out the types of services which gives more occasions for exploitation (namely those leaving to the firms the highest degree of discretion), but also the motives giving rise to a disloyal behaviour.

A number of its rules lower both motives and occasions for exploitation. For example, occasions are lowered by the duty to set up Chinese walls: if employees do not know about the businesses of other arms giving rise to firm's interests possibly irreconcilable with those of the clients, they are prevented from acting on their basis.

Motives are restrained ensuring that employees which should pursue different interests are not supervised by the same person or receive a remuneration which depends on how other business perform. Thereby, employees are not subject to external incentives to act against their clients' interests.

MiFID does not neglect the market constraints which can control the intermediaries' behaviour. The first one is represented by competition, and the European regulation embraces a pro-competitive approach. Intuitively, competition is the result (or at least the aim) of any Directive which smoothens the cross-border provision of services, both by introducing a passport mechanism and by levelling the conduct of business and other rules to which market operators are subject.

But MiFID goes beyond that in its pro-competitive approach: it clearly leaves to intermediaries themselves the choice as to the level at which they can adopt the (costly) organisational and other requirements. It emphasises firms' self determination and flexibly allows to take into consideration the type and complexity of the businesses.

The European regulator is aware of the concentrated structure of the industry, and of the fact that the market mechanisms can only work against exploitation under other restrictive conditions[1]. To counterbalance the lack of these conditions, MiFID punctually regulates through extensive conduct of business rules all the exploitations possibly arising during the intermediary-clients relationship: those arising at the point of choice of the investments or the instruments; those arising from the fact that investors' monies are 'at disposal' of the firm, those arising from the execution of the orders.

It apparently identifies in the biased investors the benchmark for the regulation: on this basis, it adopts a protectionist approach in favour of retail clients.

The suitability rule is an example thereof. The wording of MiFID seems to imply that in the provision of portfolio management and investment advice, the sole responsibility for choosing suitable investments lays with the firm, and that instructions from the clients do not take precedence over the intermediary's choice.

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[1] The fact that investors are rational and able to: detect which intermediaries, among those having possible conflicts of interest, will actually exploit them and discount the price they are willing to pay only to those intermediaries. The existence of low switching costs and of competitors actually willing and able to use the competition mechanisms.

Portfolio management shall be evaluated against a pre-determined benchmark, and forms of contractual completion are included in the rules. With the appropriateness rule, the regulation introduces a duty of 'advice' (i.e. the appropriateness test) also in services which do not confer to the firms discretionary powers.

Surprisingly, it does not enact other measures which would serve the same purpose, such as cooling-off periods which ensure that clients do not act under the pressure of aggressive selling approaches and are truly able to take the advice of information provided into consideration. It also does not introduce devices which ensure that the clients' decision genuinely comes from their part (an example can be found in the appropriateness provisions).

Some of the techniques deployed are not brought to their fullest extent: for example, with the mandatory completion of contracts firms do not have to inform clients: as to their right to terminate the contract early, on the contractual clauses and the law applicable, on the competent court and the existence of redress mechanisms – which would also reinforce the effectiveness of enforcement. This is even more bewildering since, when the instruments are marketed at a distance, such information should be provided.

The regulation also assumes that the investors suffer from consistent information asymmetries, and imposes extensive disclosure duties. They pertain to: the firm itself, the services, the financial instruments and the risks associated to them; the existence of conflicts of interest and the policy adopted to manage them; the appropriateness of an investment; the costs and associated charges; the execution venues; the effects of the order aggregation; their execution policy.

Nevertheless, the content of the disclosure does not always seem meaningful, let alone that the information overload risks be ineffective if clients are also affected by cognitive biases. Assuming that this is not the case – but MiFID would thereby contradict its first assessment of the features of investors – clients do not appear to be given the possibility to act on the information received. As a matter of example, they can not 'interfere' with the firm's suitability assessment, and nothing is said about what happens after they are informed about the portfolio management activities. But in other cases, on the contrary, clients are required to bargain with the firm on the basis of information they are not entitled to obtain from it.

The new regulation seems to be a costly one for firms. To counterbalance this MIFID adopts two approaches. First, it moulds the rules depending upon the type of service and financial instruments concerned (only implement the suitability rule for portfolio management and investment advice; applies the appropriateness rule to all other services safe for execution-only services undertaken on non-complex instruments). Second, it proceduralises the compliance with some conduct of business rules. In other words, compliance to rules passes though the undertaking of a number of formal steps from the part of the firm. For example, firms have to set up order execution and aggregation policies in which they take (and justify) once-and-for-all a choice as to the procedures they will apply when treating clients' orders. This could seem to favour investors, in that it provides them with a clear benchmark (the policy) against which the firm's behaviour can be confronted. On the contrary, it is probably more favourable to intermediaries, since compliance is not measured against pursuance of the client's best interest in the given case, but against the fulfilment of the procedures which the firm has autonomously chosen.

All in all, the full set of conduct of business rules – which apply to retail investors as the default rule – are paternalistic, show inconsistencies, and sometimes fail to have clients' interest into consideration.

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Each Chapter expands on these considerations. In Chapter III and IV I have critically analysed the whole set of rules which apply to retail businesses; Chapter V has enquired upon the specific measures enacted for the more sensitive activities from the point of view of investors' protection. In Chapter VI I have considered whether the detected dead-costs of the regulation can be avoided through the application of the general clauses, and whether the detailed provisions for retail businesses can be opted out. The focus of Chapter VII has been on enforcement, and the quality of both public and private enforcement allowed for by MiFID. Lastly, In Chapter VIII I have framed the problem of conflicts exploitation in some recent financial markets' trends.

Chapter III has focused on the Directives' two basic regulatory ideas and tools.

The first regulatory idea is that conflicts of interest are inherent to the structure (and unavoidably derive from the operativeness of) financial intermediaries and should be accepted as such. This concept has taken quite a considerable time to impose across countries, and in some of them it was still not openly stated.

It is an important pro-competitive concept: by allowing for both multifunctionality and specialisation, the Directive facilitates the decision to enter the market. This nevertheless increases the potential for exploitation. As a consequence, the pro-competitive approach, coupled with the protective approach translates in the basic obligation of managing conflicts of interest can though the tool of organisational measures, which also have to be implemented taking into consideration the circumstances peculiar to each business, and in particular its nature, scale and complexity.

A precondition for the management of conflicts is their identification. On this matter, MiFID gives important guidelines, which shall ensure that all potential conflicts are detected: firms shall have regard to the cases in which they make a financial gain or avoid a financial loss at the expenses of clients; have a own interest in the outcome of the service provided and distinct from the client's one in that outcome; serve another client, whose interests become the firm's priority; receive from a third person inducements other than the standard commissions or fees for that service; carry out the same business as the client. Both the firm's interests, those of its relevant persons, and those of other companies of the group shall be considered. Nevertheless, the concept of groups encompassed, mainly based on the idea of hierarchical control, does not capture practice of business co-operation which might also bias the intermediary's behaviour.

After the identification, MiFID guides intermediaries through the management of conflicts providing some indications thereof. The removal of information flows (though the so-called Chinese walls) between different arms or units of the same (multifunctional) intermediary is the more prominent example, and corresponds to a world-wide accepted practice.

Other measures are the separate supervision and disjoint remuneration of relevant persons acting on behalf of clients whose interest might collide. By so doing, it aims at avoiding that employees who should have the differing interests of two clients in mind do not act co-ordinately to serve the interest of one of them only.

While these measures prove useful, I aimed at showing that the goodness of the mandatory creation of Chinese walls can be controversial if the aim is that of protecting investors.

With respect to information which is already public, the walls serve no purpose. Contrariwise, they shield non-pubic information: the management arm knows for example that the firm is lead underwriter of a security, but does not know about the sudden worsening condition of a loan granted to the same issuer. As a consequence, the firm can– and has high incentives for it – place the securities in the portfolio of the clients whose risk aversion is matched by the (publicly known) risk-return ratio of the instruments issued. Bu if the sudden worsening mentioned above takes place, the investment easily becomes inappropriate for the clients to which it was offered, and appropriate for other clients previously excluded. The information being shielded avoids optimal matching, as well as business opportunities for the firm.

The solution for this would be the setting up of *ad hoc* Chinese walls, or walls permanently established but with the possibility of trespassing them depending upon the circumstances. This is not allowed since the L1 Directive mandates walls any time a potential arm to even one client is likely to arise.

Such proposal also collides with the insider prohibition contained in the Market Abuse Directive. MiFID therefore makes nothing more than rivet this prohibition, by mirroring the business practices adopted to comply with it. For the rest, the walls only convey a general perception of fairness from the part of the industry. For example, they should separate the arm which trades for the account of clients from that which trades for own account in order to avoid that own account dealing does not take place on the knowledge of clients' orders. But if the orders are consistent, this is already mandated by the Market Abuse Directive; if the orders are trivial, as it happens with retail clients, the firm has no interest of abusing the information.

The setting up of Chinese walls risks being an easy defence for firms which act on the knowledge of leaked information. As some studies have shown, outflows do take place despite the 'proper' setting up of walls. For this not to be the case, courts and authorities should be able to 'read though' complex organisational set-ups, and elaborate common approved standards. I show, mentioning the UK case-law that even taking only one jurisdiction into consideration, this is not the case.

The other regulatory pillar is that of clients' informed consent, which is pursued through the tool of disclosure.

*Ex ante* disclosure of conflicts of interest is the first example. I show that this type of information can only be extremely general – as general as the list of arms through which the multifunctional intermediary acts. Probably, this type of disclosure can serve some purpose with rational agents, which can choose to reduce their willingness to pay for the services they receive, (safe for the threat that clients indiscriminately discount their willingness to pay thereby triggering an adverse selection problem). MiFID therefore appeals to clients' rationality and their ability to trigger market discipline when they do not pay the intermediary more than its 'standing' would justify.

Nevertheless, for biased investor (and when market mechanism cannot work because of the industry structure) this information is not meaningful, and only overloads investors: in fact, it is due all the time, even with respect of conflicts which no client would expect not to exist (such as those arising when the firm acts for more than one principal at the same time).

I have argued that this provision seems to be necessary for common law States, where regulatory duties interact with fiduciary standards. Under these standards, agents cannot have any conflicts of interest, irrespectively to whether they manage them or not. To avoid that the strict application of these standards impedes all activities from the part of intermediaries, the UK financial services' regulation has always embedded a mechanism of interests disclosure which, coupled with the client's consent allows intermediaries to undertake their activities. The idea that this requirement bears more formal than substantial importance is reinforced by the fact that the regulation does not state whether and how investors can act upon this information, which has to be provided only once at the beginning of the relationship.

The formalism triggers the concern that investors could opportunistically use the failure from the part of the firm to provide information to void an otherwise effective contract as soon as the market conditions turn against them. The result would be that firms end up bearing a risk which investors should have consciously taken, a risk that no regulation – even the more protective – could avert from investors.

Clients have to be provided with other extensive *ex ante* information. This is paternalistic in that it obliges firms to undertake costs and bridge information asymmetries which they would not otherwise bridge, but is paternalism in its lightest-touch form (and in a form which more directly addresses the market failure of information asymmetry), since it puts clients' autonomous and aware decisions in the foreground. It gives account of the fact that the players on the market have different degree of professionalism: the least sophisticated ones are given the tools to avoid errors, while the good choices of the sophisticated ones are not prevented.

Nevertheless, going through the intricate web of rules on this matter, I find that the level of detail of this disclosure is not sufficient for investors to be truly informed. This should have been more closely considered by MiFID, since the technique of information disclosure has a number of downsides: agents tend to feel morally licensed after having provided information to their principals, while the information overload risks exacerbating agents' cognitive biases.

Chapter IV has enquired upon the other tools provided for ensuring that investment services are performed without conflicts exploitation.

I have grouped the conduct of business rules around the types of exploitation which they endeavour to avoid. Exploitations due to the choice of the instruments; those due to the execution of the orders, those due to the fact that intermediaries have clients' monies at disposal. I have also separately considered the exploitations arising from the common-agency set-up.

At the point of choice, the suitability and appropriateness tests apply. They translate to different degrees the paternalistic approach of 'mandatory advice'. The suitability rule applies to the high added-value services of investment advice and portfolio management, whereas the appropriateness applies to all other service (safe for execution-only services on non-complex instruments).

Suitability puts in the hands of the firm the judgment as to the aptness of the investment to the client. This judgment has to be performed on the basis of the information gathered from the part of investors. MiFID is nevertheless extremely formalistic insofar as it does not allow to perform service when the client refuses to provide information. Thereby, it does not consider the possibility that the highest risk aversion can always be presumed, and frustrates the interest of ensuring that advice is at disposal of clients to the largest extent possible.

Also, it does not allow the client to take control of the investment decision after having received the advice of the firm. As opposed to what assumed with the provisions mandating information about the existence of conflicts, here the investor MiFID has in mind is one completely incapable of judging what would be in her best interest. This can indeed have some justification, if only one considers that intermediaries stand out as professionals acting for the clients' interests and investors are thereby more likely of being fooled.

But this renders purposeless the flow of information to the client which, despite being entitled to know about firm's inducements, costs etc., cannot act on this information.

Let alone the problem of insider dealing, investors could nevertheless have more information at disposal than the employee if, as seen in the discussion of Chinese walls, some information does not (legally) flow between departments of the firm. It is not irrelevant from this point of view that the suitability rule also applies to professional investors.

Instead, after the appropriateness test, clients are free to act. At leas apparently, since MiFID does not explain what should happen after the firm has warned the client about the inappropriateness. What can be criticised about this test are the circumstances which intermediaries should consider to issue their opinion. Clients are protected not if firms make sure that their current investment mirrors the ones previously undertaken, but if the current investment entails diversification while matching the clients' current aversion to risk and financial capability.

MiFID regulated inducements, i.e. monetary or other benefits accorded to the firm from a third party (the provider in particular). The aim is to impede product- or provider-biases of the firm on which basis it can influence investors.

I have held that the conditions under which they are lawful (in particular the circumstance that they enhance the quality of the service) are surely obscure, and maybe too restrictive. CESR has often intervened on the point, reinforcing the strict approach.

I held that such approach can be problematic: business practices have shown that inducements are sometimes needed to ensure the provision of services and, under certain market structures, they would be needed to enhance the competition between products and providers.

The possible exploitation of clients through the use of their monies otherwise than for their benefit is addressed by the rule on cost disclosure, which is crucial for enhancing an effective market discipline. Nevertheless, these provisions do not appear to accord full transparency for cases where the costs for investors are more obscure, such as bundling. The rule on inducements could supplement, since they also provide for disclosure duties, but in this case the practice would risk not passing the other tests of the rule against which lawfulness is measured, although it sometimes makes sound business sense to deploy it.

The risk of overtrading at the expenses of clients is addressed by the suitability rule. The practices of softing and bundling can also be an incentive to over-trade. Nevertheless, CESR has backed-off on their respect, and States now consider them a national matter.

At the point of execution, exploitations are addressed by the rules on best execution and the order handling rules. I have made a point common to both. Compliance with these rule is highly proceduralised: firms have to establish and respect their own policies on these matters, and investors risk not being accorded any relief, shall the firm prove that the behaviour in the specific circumstance has matched the policy. In addition to this, I have shown why the client order handling rule, providing for the aggregation and allocation of clients' and firm's orders, should have been applied to portfolio management as well.

This rule also applies to the aggregation and allocation of order issued by different clients. This is the way in which MiFID addresses – with measures other than those on organisation – the problem of exploitation in the common agency set-up.

Chapter V considers more in-depth the specific measures enacted by MiFID for the services which more heavily expose clients to a risk of exploitation, as identified by CESR.

Systematic internalisation (which is result of intermediaries performing together the services of dealing on own account and for the account of clients and renders firms new trading venues) is the first of them.

Firms contextually acting as service providers and trading venues have an interest in retaining the orders for execution in-house when they have a proprietary position matching the client's orders. Investors' interests are exploited when this type of execution does not bring them the best possible result in terms, for example, of price they pay for the transaction.

To address these cases, both the pre-trade transparency and the best execution rules are devised. The former ensures that intermediaries do not disguise – and therefore alter depending upon the circumstances – the price at which they are willing to buy or sell securities. Although it leaves intermediaries some leeway, it is not likely to be abused by intermediaries which otherwise risk loosing some orders, or that their quotes are hit or avoided.

The best execution rule, which generally applies to all orders, contains some provisions explicitly addressing the threat that intermediaries retain the orders for execution in-house, despite this being against the client' best interest. In particular, it prohibits firms from inflating the costs they charge for execution other than in-house, which could otherwise be done to disguise the fact that the execution on other venues would better suit the client.

The second service which benefits from a specific regulation is that of portfolio management. The application of the suitability rule aside, MiFID provides for two mechanisms peculiar to this service: *ex ante* limitation of discretion and *ex post* control over how the discretion has been employed. The former is ensured though two mechanisms: the contract shall pre-determine the features of the management; by default some instruments cannot be included. The latter is based on disclosure.

If one agrees with the fact that when the risk of exploitation is high, the benefits of limiting the discretion of the most informed party outweigh the drawbacks, both techniques shall be welcomed. I have shown that the drafting of the related rules shows some inconsistencies. First, the directive should univocally empower investors to take actions after they are informed about the management activities, in case they should be dissatisfied. Second, the definition of a benchmark against which the performance of the portfolio can be assessed shall be clearly made mandatory. Third, reading together some provisions, it becomes clear that the choice as to the inclusion in the portfolio of the instruments which are by default prohibited lays with the discretion of the firm. Fourth, despite what said so far, the directive assumes that investors are able to bargain on aspects such as the amount of losses to the portfolio which trigger additional disclosure duties.

In Chapter VI, I have enquired the extent to which the over-paternalism, the inconsistencies, and the failure to sometimes take clients' interest into consideration can be solved through the application of the general clauses and an opt-out mechanism.

I have shown that MiFID adopts a mixed approach to the application of the general clauses of honesty, fairness and professionalism. It refers to them but also contains some provisions which apparently endeavour to conclusively define their content. Moreover, with the rule on employees personal transactions it proceduralises the control over a behaviour which should be measured against the concept of fairness and honesty. Lastly, with the rules on clients' orders execution seem to have replaced the general clause of loyalty with that of equal treatment.

Despite this, I held that their applicability shall be affirmed, and have summarised – drawing form the previous chapters – the cases in which they can be usefully deployed. I have also rejected the idea that the rules as moulded through the application of the general clauses by national authorities can only be lawfully applied to national firms.

The aim of maximum harmonisation is thereby contradicted. In light of some recent debates, I have shown that the different approaches used by Member States for the 'management' of the general clauses will probably further un-level the playing field.

In the second part of the Chapter I have evaluated how broad the application of the whole default system is. For this purpose, I have compared the MiFID to the UK and the Italian pre-MiFID category of retail clients and found that the European Directive encompasses far more investors than the national regulations did.

I have also verified how easily the system can be opted out from, by considering the grandfathering provisions of MiFID, as compared to the Italian and English ones. Under MiFID, retail clients can be categorised as professional clients under more restrictive and proceduralised conditions than under the FSA's Handbook. The comparison with Italy allows for different conclusions: under the TUF and Consob's implementing regulation there was ample margin of manoeuvre for the grandfathering of companies, since the law only required a statement from the part of their legal representatives as to the professionalism of the entity. This light-touch approach was nevertheless highly criticised.

Lastly, I have evaluated how much opting-out is allowed for. To answer this I have compared MiFID's treatment of professional clients against the pre-MiFID Italian and English ones. These latter featured a much lighter approach. Importantly, Italy had a rule which left freedom of action to portfolio managers: this enforced the view that, at least where clients are on the footing of otherwise disciplining firms' behaviours, the costs of limiting the most informed party's discretion outweigh its benefits. On the contrary, MiFID's waivers to the conduct of business rules are justified more from the point of view of firms' costs of compliance, than from the point of view of reducing the paternalism when investors have other means of protection.

The European regulator was aware that the need for protection of different categories heavily depends upon the national markets and the idiosyncratic features of the agents thereon, and that clients' categorisation should better be left a national concern. On this basis, it allows States to automatically grandfather (as eligible counterparties) almost all professional clients by default, and to permit professional-upon-request clients to require the treatment as eligible counterparties. It is easy to foretell that the option brings back the unwanted consequences of the ISD: depending upon each States' choice, firms dealing with the same type of clients risk being subject to different regimes.

The positive remark is that the default regime is further lightened, since the protection is almost completely replaced by the bargaining between parties. It is nevertheless puzzling that also the provision on fair, professional and honest treatment is waived for eligible counterparties.

Chapter VII has elaborated on the quality of enforcement under MiFID. In the outset, I have evaluated the different forms of enforcement, their benefits and drawbacks especially in the field of investment services. This allowed me to point out the aspects on which the European regulation could have usefully introduced new rules, but failed to do so. I then turned to the aspects which are directly or indirectly touched upon.

MiFID indirectly touches upon the matter of private enforcement, which is rendered more difficult. This happens because its conduct of business rules overlap with national contractual rules which the directive does not harmonise.

MiFID's conduct of business rules refer to (and imply the application of) concepts – such as the conclusion of an agreement – which clearly remain of the domain of national contract law rules. It might then be the case that the conflict-of-law rules generally applicable (Rome I convention in particular) point to one jurisdiction for the interpretation and application of such concept, while the conflict-of-law rules identified by MiFID for the application of the conduct of business obligations point to another one. It is not clear which jurisdiction should prevail in these cases.

Lastly, since MiFID lacks all forms of coordination with the Rome I convention, there is a risk that its protection is circumvented by intermediaries suggesting (or imposing) the application of a third country's regulation.

The efficiency of public enforcement is surely improved as compared to the ISD: MiFID has reduced the cases of dual supervision of cross-border businesses (currently applicable only to branches), has expanded the powers of Host States to ensure that the rule-making powers are accompanied by enforcement powers, has laid the foundations for an intense cooperation among authorities. Nevertheless, Home States risk being overloaded by supervisory activities, which could make them concentrate their efforts on the breaches taking place in their jurisdiction and disregard those perpetrated elsewhere by their firms acting cross-border without establishment.

MiFID also creates a mechanism of 'reciprocal control' among national authorities. If used, it can solve the problem of public enforcement not being effective enough because, for example, authorities tend to retain their consolidated approaches and their activities become predictable by market operators. The mechanism allows the national authority of any State to signal to foreign authorities possible braches committed by firms under their jurisdiction. Also, it allows Host States to take measures against breaches which would fall under the Home State's competence if this latter does not act, or its measures prove inefficient.

Lastly, the L2 Directive contains a provision which can only very hardly be interpreted as allowing for information exchanges between supervisory authorities and courts, as it would be efficient to allow for economies in the information gathering process, and to ease private enforcement.

Lastly, Chapter VIII has verified whether clients are adequately protected against conflicts of interest exploitation in light of some recent financial markets' trends.

The first one is the substitutability of products which can all be marketed by the same intermediaries. This creates the need for a comparable level of protection across products in order to: ensure that investment decisions are taken on the sole consideration of the clients' financial needs; avoid that clients' lack of confidence spreads across products, and that intermediaries arbitrage among product-specific regulations.

I focus on insurance products and UCITS' units. For insurance products I show that: the adequateness rule is looser than that the one applicable for the MiFID-relevant financial instruments; the distributors' remuneration structure is too opaque to allow clients to perceive the conflicts of interest it might entail.

The sub-category of unit-linked products should be (and is not) treated with even more thoughtfulness: they have an investment component on which the clients' attention has to be drawn, and their linkage to UCITS brings into play an additional agent (the UCITS' manager) whose interests can be pursued by the distributor with preference to those of its clients.

I posit that a work at the EU level should be undertaken on the matter of disclosure, and explain why this effort necessarily brings also the matter of distributors' organisation in the foreground.

Concerning UCITS' units, I have shown that the application of MiFID's rules solve some problems of conflicts of interest exploitation. Other issues are not covered by the directive, whose provisions are not specifically tailored on these financial instruments.

For example, the rules on commissions should not be applied too strictly: given the current structure of the industry, the distribution of units requires distributors to be consistently remunerated; lacking such a remuneration, their willingness to undertake such business would be compromised, with the consequence that investors would lose this investment possibility.

MiFID also does not contain rules which sufficiently consider the problem of intermediaries investing individually managed portfolios in units of the UCITS they market: a practice which inflates the fees paid by investors without always providing for clear benefits.

Lastly, MiFID allows intermediaries to treats UCITS' managers for which they undertake fund transactions as eligible counterparties: it therefore waives the application of a number of conduct of business rules. This could facilitate managers willing to act in a self-interested way to the detriment of unit-holders.

In addition to this, the chain which starts with the product-design and ends with its sale to investors develops through different stages and involves a number of players. Each of them enters the chain carrying own interests, possibly conflictual with those of the clients, so that the potential for exploitation expands grandly.

The UCITS Directives shall be 'blamed' for not solving them, not MiFID. Such directives stress the importance of controls exercised by external independent bodies (exercised by a depositary, an auditor and the like) over the activities of the UCITS' manager. Nevertheless, these bodies mainly ensure that the manager complies with the fund's rules or instruments of incorporation, which are autonomously devised.

True is that the fund's rules and the instruments of incorporation have to fulfil national rules, which might well set mandatory requirements for the protection of investors. Nevertheless, this does not ensure a common level of protection as that laid down by MiFID for other financial instruments. Large parts of Directive 2004/39 could be easily (and usefully) applied to managers as well. This holds particularly true for the rule mandating the best execution of orders: it could be translated for managers in the duty to choose the broker which ensures the best execution for UCITS' transactions.

The second trend I emphasise is the development of distance marketing techniques. They create the case for a faster pace in the work of approximating applicable rules for products which currently do not ensure a minimum level of investors' protection across the EU. Indeed, these techniques allow for cross-border marketing of all types of products, irrespectively to the passport mechanism and to whether their national regulation (if any) is sufficient to ensure protection against exploitations.

This also calls for a new wave of supranational regulation which should likewise ensure a levelled treatment among different means of marketing (for example on-line and opposed to off-line). Otherwise, intermediaries could arbitrage among them in order to circumvent the protections otherwise applicable for the benefit of their clients.

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The regulation of the provision of investment services requires some compromised to be made. The first of them appears in the choice of the aims to pursue: investors' protection and market efficiency are mostly interrelated, but sometimes the furtherance of one of them implies that the other is sacrificed[2]. Hence, the first compromise lays with the choice of which of the two dimensions shall be emphasised[3].

Some protective regulatory techniques have commonly been rejected (as they probably should) for the damage they would bring to market efficiency.

The first technique rejected is the introduction of dealing prohibitions, beyond the case of suitability. When intermediaries refrain from conducting certain business, important economies of scale and scope risk to be lost, and this hacks the very core of multifunctionality, affecting the entrepreneurial freedom in a way which might be sub-optimal for the financial development. Also, refraining "may lead to unintended consequences such as alerting the market to an impending transaction"[4].

The same held true for a number of national pre-MiFID European regulations. For Italy, the 11522 Regulation as interpreted by Consob went down this path on the same topic of suitability assessments. German scholars have more generally argued against refraining. Even among those who have argued that this might be a last-resource solution[5] it is nevertheless common to argue that, in practice, refraining does not take place[6].

Nevertheless, the matter has recently been brought in the foreground in other supranational fora: IOSCO[7] lists refraining among the conflicts' management devices, stating that "policies and procedures should give clear guidance as to the process and the circumstances in which a conflict is unlikely to be able to be effectively managed and where the market intermediary or other group entity should refrain from acting, including as and when circumstances change"[8]. Also in IOSCO's view, though, refraining shall be treated as an *extrema ratio*, only applicable after throughout consideration on whether, and why, other remedies prove insufficient.

IOSCO's position of dealing prohibitions has triggered several criticisms[9], but has also acted as harbinger of new ideas: some respondents have opened up to the possibility that an objective assessment of the situation and the extent to which the group depends upon the success of the operation could be a basis for refraining[10]. All this makes clear that the word spoken through MiFID is far from being the conclusive one.

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[2] Kumpan, Leyens (2008), pp. 95-96.
[3] "Investor protection in a liberalised international marketplace could be argued to depend on the promotion of effective diversification practices which might suggest that regulators should facilitate access to foreign investments even at the cost of some lessening of the degree of protection provided or at least non-uniformity in the mechanisms of investor protection": Kern, Ferran, Jackson, Moloney (2007), pp. 4-5.
[4] See the responses IOSCO's Consultation Report, IOSCO (2007), August. The quotation derives from IOSCO (2007) November, Annex, 29.
[5] Koller (2006), § 31 WpHG, para 58; Eisele (2001), § 109 para. 22.
[6] See for ex. Göres (2004) p. 87.
[7] IOSCO (2007), p. 14.
[8] IOSCO's Final Report identifies the changes which could require the intermediary to refrain from dealing: "the issuer is facing financial distress and has outstanding loans to a member of the group at the same time that the market intermediary … underwrite[s] an offering of securities on behalf of the issuer".
[9] See industry representatives' responses to IOSCO (2007a).
[10] Max Planck Institute, in IOSCO (2007b), p. 73.

MiFID also seems wary as to the introduction of tables of correspondence between investments or investment types, and types of clients. This matter is likely to arise again, either in CESRs' the management of the coordination practices among Member States, or in national implementations. Some Member States (France, for example[11]) have implicitly adopted this approach before MiFID, and others (Italy[12]) have – but just briefly – embedded it in their regulation.

This idea is nothing new in the supranational debate. The Australian Financial Markets Association's response to the consultation promoted by IOSCO[13] has for example proposed that when intermediaries back an issuance of a distressed firm (to which they might also have previous lending relationships), they could label the issuance as such ('distress issuance') in order to not disguise what the right matching investor-investment would be in light of the issuance's risks, and to allow for a pricing which compensates clients for undertaking such risks.

Problematically, where brought to its extremes consequences, also this 'table of correspondence mechanism' has major drawbacks: in particular, it is a too rigid approach which disharmonically fit with the current pace of financial innovation.

Other paths which could be gone down pertain to the production of a regulation which is either product- or service- or means-specific.

I have argued in favour of a common level of protection among (comparable classes of) products. What should be commonly set, though, it the minimal level of protection, while its upper boundaries can well be identified depending upon the specific features (in terms of both risks and opportunities) of different products.

Examples for this can be found in the UK[14] and in the US[15], which have devised specific rules for the so-called 'packaged products' (life assurances, UCITS' units, pensions and investment trust savings schemes) and the structured products, respectively. The problem of this type of regulation lays with the fact that the regulator unavoidably comes after the markets' innovations and is required to apply a high level of sensitiveness in order not to frustrate the efficiencies allows for by different products. Last but not least, where the financial innovation reaches its highest peak, it might become prohibitive to identify homogenous groups of investments.

I have also argued that the protection accorded to clients should not differ depending upon the means used for the marketing of products. Here again, I back uniformity only insofar as the efficiencies specific to each type of means do not risk being frustrated[16].

All the further refinements shall take into account the explicit costs, as well the opportunity costs: the costs of losing investment possibilities, of denying access to a part of investors, of slowing down the wave of financial innovation.

[11] AMF (2005), pp. 29-30.

[12] See the second sentence of art. 21 (1) lett. a, (as added by art. 14 of law n. 262 of 28 December 2005), following which Consob, in conjunction with consumers' representatives associations, was to adopt a regulation containing minimum criteria which would help firms: to distinguish financial products by risks entailed; to class the clients on the basis of their expertise, and to finally identify the adequate matching between products and investors.

[13] Australian Financial Markets Association's response, in IOSCO (2007b), August, p. 17.

[14] See FSA (2007d).

[15] Bethel, Ferrell (2006).

[16] As an example, the communications circulated over the internet should be held compliant with the rules mandating the transmission of information "in a durable medium".

For sure, the European regulator will also increasingly have to consider the opportunity of attaining some from of coordination among national contractual rules. So far, though, it is not clear whether both it has the legal basis for this purpose, and Member States will accept such invasion in their jurisdiction[17].

After the recent market turmoil, regulators' attention has been more concentrated on the issue of prudential regulation and markets' stability. Moreover, as a consequence of the turmoil, the shape of the main financial markets' intermediaries (and of the industry) has changed: a number of investment banks have been either bailed out or 'rejoined' with a commercial bank undertaking.

It will consequently take sometimes before all the possibilities above will be conclusively considered. And it will also take some times before all the connected problems – which emerge little by little and now for the first time, such as that of foreign investors' participation to national insolvency procedures, will be solved.

[17] See Parlamento Europeo (2005).

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