“Conflicts of interest in financial services”

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Ladies and gentlemen,

After Eddy’s penetrating analysis of conflicts of interest within financial groups, which may endanger the solvency of some of the groups’ components and affect the interests of their shareholders and stakeholders, which, fortunately, does not happen frequently, my presentation will focus on day to day conflicts which affect market participants.

I shall, firstly, analyse the phenomenon as it develops in the financial field, and secondly, analyse the way EU regulation tries to protect market participants from the perverse effects of such situations.

1. Conflicts of interests are a fact of life and tend to thrive in financial activities for different reasons.

Let me characterise some of the main situations.

I would like first to mention the case of issuers. One of the classic conflicts was analysed by Berle and Means in the aftermath of the 1929

crisis, and it has to do with the complex relationship between the shareholders and the management of public companies, between the principal and the agent, as the theory goes. I shall not expand on this kind of conflict, as not all financial regulators are competent in that field. I shall only refer to the recent development of corporate governance regulation, which aims at preventing or managing these conflicts through a series of principles based on checks and balances, together with transparency. I should also mention that, while they were not, initially, keen to focus on these issues, securities regulators have recently undertaken some work on corporate governance at the level of IOSCO, following the scandals of the beginning of the new millennium. EU authorities themselves are indeed moving in the same direction as shown by the recent developments in the field of auditor's independence, internal controls of listed companies and corporate governance. You must have heard of the Winter report.

But I guess the 3L3 is more focused on financial intermediaries, where the opportunities for conflicts of interest are indeed multiple and derive from a number of situations.

Conflicts may develop because of the diversification of activities within the same firm or group and, subsequently, diversification of clients and stakeholders. Investment banks may, for instance, arrange and underwrite offerings for issuers, produce financial analysis on the same operation for investors, trade the same securities for their own account, and so on… Another classic conflict due to multi-capacity is raised by the coexistence of credit and equity activities with the same client. Trading for own account, together with managing assets on behalf of third parties is another source of conflict which may give rise, for instance, to front

running. Generally speaking, multi-capacity is, per se, a potential source of conflict of interest. From that point of view, recent developments in the financial industry have probably increased the risks: concentration of firms, development of conglomerates, disintermediation and transfer of risks to the markets raise new and complex issues which regulators and market participants are struggling with.

A well known source of conflict can be found in the systems of remuneration of service providers and, more specifically, in inducements, where the interest of the client conflicts with the interest of the service provider. In that case, conflicts may be very simple: an asset manager may, for instance, unduly speed up the rotation of a portfolio to increase the amount of transaction fees, so-called "churning". They may be more complex, for instance when several service providers act in a coordinated way to advise, market and sell products to their clients and use kickbacks or soft commissions in a way which is both hidden and detrimental to these clients. The Joint Forum, at the global level, and the 3L3 are studying these issues raised by both traditional and new systems of distribution of financial products.

A new source of conflict has recently developed in the financial sector, as a consequence of the demutualization of market infrastructures. In many countries, exchanges and post-trade facilities have long been mutually owned utilities. It was quite rational, in such a situation, that they be given regulatory missions as well as self-regulatory capacities. While these organisations are becoming for-profit entities and even public companies, the continued validity of certain of their self-regulatory functions, for instance listing, as well as their enforcement role is called into question. New competition issues appear, for instance the possible

conflict of interest raised by the “silo” model or the possible conflict between banking activities and central depository functions. This is, for example, why the FSA recovered the listing authority in the UK, and the regulatory function of the NYSE has recently been merged with the NASD.

It is indeed not easy to address the issue of conflicts of interest from a regulatory point of view. The industry develops many arguments to defend industrial, technical, organisational and financial arrangements which originate possible conflicts of interests and these arguments may be persuasive. Saving costs by sharing the same systems for different purposes, combining different skills to improve the quality of services to the client, using commercial networks to diversify the products offered etc…it cannot be denied that from a cost-efficiency point of view, all these ideas make sense .

Financial services regulation therefore sways to and fro, according to the priorities of the moment, which are defined by the occurrence of the risks associated with situations of conflicts of interest. US history is emblematic of these never-ending evolutions.

Regulators can use different tools to deal with these issues. Basically, they use three sorts of instruments:

they can forbid the combination of conflicting activities;

they can require from firms specific arrangements to minimise the risk ;

they can rely on transparency, assuming that, by making the conflict public, investors and stakeholders will be able to beware.

2. How do we regulate conflicts of interests in the EU today?

I shall focus my presentation on the MIFID which will come into force in November this year and which is being transposed into national law- with some difficulty- by legislators and regulators of all member states.

Indeed, no prior legislation has ever addressed conflicts of interests in the same depth as the MIFID which is, in principle, a fully harmonising directive, so that member states are not allowed to add more stringent provisions.

One should nonetheless mention other directives which also address the issue of conflicts of interests.

The Market abuse directive, which applies to everyone, not only financial institutions, prohibits the misuse of non public information and, more precisely, requires the disclosure of conflicts of interests in investment research and recommendations.

The UCITS directive of 1985, as amended, provides that the UCITS management company is structured and organised in such a way as to minimise the risk of UCITS' or clients' interests being prejudiced and tries to avoid conflicts of interest and when they cannot be avoided, ensures that the UCITS it manages are fairly treated.

Finally, the ISD of 1993 contains almost exactly the same provisions as the UCITS directive in its articles 10 and 11.

As these are very general provisions and because these directives are of a minimum harmonisation kind, one can imagine that this has led to a great diversity in the rules and regulations of member states, which explains why the Mifid had to be more specific. At the same time the Mifid had to build a compromise between very different traditions and was inspired by a philosophy of free competition which did not allow for prescriptive rules with regard to the structures of firms and activities. It is a principles-based directive which allows for very different types of competing models in the financial services industry.

Given the broad range of activities covered by the MiFID—investment advice, individual portfolio management, execution of orders on behalf of clients, dealing on own account including market making, marketing communications, investment research[1], underwriting and placing with respect to all financial instruments including units in collective investment undertakings and derivatives—it is highly relevant for today's discussion to attempt an initial assessment of the likely impact of the MiFID's provisions on the management of conflicts of interest. To do so, I need first to recall that what the MiFID calls "investment firms" includes credit institutions that provide investment services, and then I need to recall the principal requirements of MiFID in this area.

The framework directive (Level 1) requires the investment firm to take "all reasonable steps" both to identify conflicts of interest between itself, including its management and employees and any affiliated entity, and its clients, or between one client and another, and to "prevent conflicts of interest from adversely affecting the interests of its clients" (articles 13-3 and 18-1). It also requires conflicts of interest to be disclosed to clients where such steps "are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented" (article 18-2).

The framework directive also provides, contrary to the ISD, that conflict of interest regulation and supervision falls exclusively within the

[1] I will not address the detailed provisions of the implementing directive that apply to investment research (articles 24 and 25).

jurisdiction of the home Member State, regardless of where the relevant services are provided.[2]

The implementing directive (Level 2) specifies that the relevant conflicts of interest are those that arise in the course of providing investment services, including where the conflicts arise in connection with any other activities of the investment firm or its group (article 21). MiFID therefore encompasses *inter alia* conflicts arising from banking, insurance and UCITS management activities, whether they are performed by the investment firm itself or an affiliated entity.

The implementing directive also requires the investment firm to establish and implement an "effective conflicts of interest policy" that is "appropriate to the size and organisation of the firm and the nature, scale and complexity of its business" and takes into account "the structure and business activities of other members of the group" (article 22-1).

The implementing directive further requires the investment firm to put in place "procedures and measures" that are "designed to ensure that relevant persons [employees, management, etc.] engaged in different business activities involving a conflict of interest ["entailing a material risk of damage to the interests of one or more clients"] carry on those activities at a level of independence appropriate to the size and activities of the investment firm and of the group to which it belongs, and to the materiality of the risk of damage to the interests of clients" (article 22-3).

[2] Inducements, however, are within the jurisdiction of the host Member State when the relevant service is provided by a branch located in that Member State.

The implementing directive then lists several types of “procedures or measures” to be implemented “as necessary and appropriate for the firm to ensure the requisite degree of independence”: information barriers, functional independence and separate supervision of relevant persons, removal of remuneration links likely to generate a conflict of interest…

Last but not least, the implementing directive states—and this is the nuance concerning the maximum harmonising effect of the MiFID—that “if the adoption or the practice of one or more of those measures and procedures does not ensure the requisite degree of independence, Member States shall require investment firms to adopt such alternative or additional measures and procedures as are necessary and appropriate for those purposes” (article 22-3 in fine).

It is of course impossible to assess the precise impact of MiFID on the extraordinary variety of conflicts of interest that arise in the field of investment services. The point I wish to make is the following: the MiFID creates a complex and finely tuned regulatory scheme in order to address a complex area of regulation, and most Member States will very likely add little or nothing to MiFID’s relatively detailed but also relatively high-level set of provisions that refer repeatedly to what is reasonable, necessary and appropriate in the circumstances. It will therefore be indispensable to see how these provisions are interpreted by regulators and applied by firms. Supervision and enforcement of MiFID’s conflict of interest regime is therefore likely to be one of the major challenges for European financial regulators in the years to come.

To conclude, conflicts of interest are everywhere in our field ; they may be a source of huge undue profits ; they are a formidable challenge to

regulators and to the regulated since human behaviour is largely dictated by personal interest; and they can potentially do much harm to issuers, shareholders, investors and the integrity of our markets. Even regulators themselves are conflicted, because regulation itself is subject to competition. We are all required constantly to seek a balance between investor protection and market integrity on the one hand, prudential stability on the other hand, while at the same time not unnecessarily handicapping market players that are immersed in a complex and highly competitive business environment.

It is therefore of utmost importance that our level three committees play an active role to ensure the good functioning of our network of regulators. This is a challenge for each of them. It is also a challenge for the 3L3 collectively.