Conflicts of interest: a potential pressure point in the regulatory reform project

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“The continuing concentration of [investment banking] business into ever fewer hands opens the door to substantial conflicts of interest. The ‘financial supermarket’ model allows banks to advise companies, sell them financial products and also trade on their own account in those products. It is not clear that the companies that buy investment banking services are sufficiently alive to the pitfalls...”

Editorial, Financial Times 21.03.10

In the aftermath of the financial crisis many regulatory initiatives have been proposed or implemented to try to encourage banks to adopt what regulators regard as sound and prudent business models. Although approaches have varied between jurisdictions, reflecting a diversity of politics, culture and legal systems, all of these various initiatives seem to have two broad but interlinked objectives in common:

- the removal or reduction of risk; and
- the simplification of the structure of major financial institutions so that failure becomes easier to manage.

As regards the first objective, the primary focus has understandably been around regulatory capital reforms designed to increase the quantum and quality of regulatory capital in the banking sector and to reduce excessive leverage, and reform of commercial policies and practices which improperly incentivise risk-taking. Some regulators and commentators consider that these reforms will also support the second objective by incentivising some firms to give up higher-risk, and therefore higher-cost, trading activities.

But there is also another area that regulators are beginning to explore, albeit initially in a somewhat fragmented way, namely, the fundamental relationship which financial institutions, and particularly investment banks, have with their clients. A question which is now beginning to emerge is whether that relationship is fair and client-serving, as opposed to merely firm-serving. Regulators and policy-makers are clearly starting to express their doubts, although there is, as yet, no significant clamour for change from the corporate client base of the investment banks.

The FSA’s CEO, Hector Sants, in a recent important speech on the FSA’s supervisory approach, has referred to the “… issue of culture and behaviour – dare I say it, ethics? Poor risk management was a key driver of the crisis… My personal view is that if we really wish to learn lessons from the past, we need to change not just the regulatory rules and supervisory approach, but also the culture and attitudes of… the management of major financial firms”.

But also, in recent weeks, influential industry voices, including the ABI1 and the OFT, have started to question the business models which currently prevail among major financial institutions, especially as regards the levels and incentivising effects of investment banking fees.

In this paper we suggest that one of the tools that regulators might consider using to tackle these perceived imbalances in the industry is an insistence on more rigorous management of conflicts of interest, to the point, perhaps, that firms are required fundamentally to rethink the basis on which they currently carry on business. Such action could be attractive to regulators because it would also likely support the two key policy objectives of risk reduction and structural simplification. But we also suggest that such action could have broader negative effects if taken in a disproportionate way.

1 Letter to Lord Mandelson, 19.03.10
What legal and/or regulatory tools are available in the UK?

Since long before such matters were addressed in regulatory rule books, English law has imposed special duties (known as fiduciary duties) on a person whose relationship with another is such that the latter places reliance and confidence in him (a fiduciary).

Traditional examples of such relationships include those of trustee-beneficiary, lawyer-client and agent-principal, each of which involves one party 'looking after' the interests of the other, dependent, party. In the financial services sector persons who are generally assumed to be fiduciaries include agency brokers, advisers, fund managers and custodians (but not pure deposit takers, or market makers and dealers who do not purport to act in the interests of their counterparties).

Fiduciary duties in their bare form are relatively onerous. The common law rules governing fiduciary relationships provide that:

- a fiduciary must not place itself in a position where its own interests conflict with those of its customer (the "no-conflict" rule);
- a fiduciary must not profit from its position at the expense of its customer (the "no profit" rule); and
- a fiduciary owes undivided loyalty to its customer and therefore must not place itself in a position where this duty towards one customer conflicts with a duty that it owes to another customer (the "undivided loyalty" rule).

It would in practice be impossible for a modern financial services firm to discharge its fiduciary duties if these rules were to be applied rigidly, in full and without modifications. At the very least, such rules need to be modified to permit a firm to charge for its services and to act for more than one client in circumstances where one client’s interests might conflict with another’s (such as where a firm acts for a number of clients who may be competitors in the same business sector).

Sometimes such modifications may be implied by law from the nature of the business, but traditionally financial services firms have sought to modify the application of fiduciary duties by making express provision in contractual arrangements with their clients, to allow for such matters as:

- keeping knowledge of a client’s affairs behind a ‘Chinese wall’ and permitting other parts of the firm to carry on business, for certain purposes, in a manner that could otherwise be inconsistent with the no conflict rule and the undivided loyalty rule;
- receiving commission or fees from product providers, counterparties or intermediaries; and
- dealing for its own account or the account of other clients in securities dealt in on behalf of a client.

The principal legal technique by which fiduciary duties may be modified at law is that of 'informed consent': the client is informed of actual or potential conflicts and, as a matter of contract between the client and the firm, agrees that such conflict will be allowed to arise or persist. A more radical approach for achieving the same end is for the firm and the client to agree that the firm is to owe no fiduciary obligations at all. This may be possible in certain contexts (for example, in an execution-only dealing relationship with an experienced investor) but the approach cannot credibly be applied in a case where there is to be true reliance by the client on, for example, the firm’s expert advice or on its discretionary management of assets.

What constitutes properly “informed” consent is a complex topic and the view of the courts has varied according to the circumstances. In general the courts have said that the more acute the conflict the more detailed the disclosure must be for consent to be truly informed.
To restate the important fact: a complex firm such as a full service investment bank needs to find a way to modify or disapply its fiduciary obligations in order simply to carry on business-as-usual activities. As noted, there is, of course, nothing in the common law to prevent this consensual modification of duties. But, equally, there is nothing which would prevent the FSA from making a rule prohibiting such modification, or at least severely restricting it, if the FSA were minded to do so.

**What is so fundamental about conflicts management?**

At the highest level conflicts of interest have the potential to emerge in any business model where:

- a firm acts for, or advises, clients and also acts for its own account in respect of the same or related business activities;
- a firm’s charging policies might incentivise the firm to put its own interests before the interests of clients;
- a firm favours some important clients, directly or indirectly, to the possible detriment of its other clients; or
- the marketing of products or services to clients is driven by the profitability of the business for the firm rather than the suitability of the product or service for the client.

In the UK retail markets we are already seeing the FSA take a new tougher regulatory approach, attacking these features: as well as the numerous occasions on which the FSA has played enforcement ‘catch-up’ with various mis-selling scandals, the FSA is about to bring in fundamental pricing reforms aimed at eliminating the traditional commission-based advice model in large parts of the retail intermediary sector, on the basis that it sustains a fundamental conflict between the interests of intermediaries and their clients. The FSA has also recently announced that it will now be prepared to engage in more specific product regulation with a view to preventing mis-selling practices developing in the first place.

The points of principle involved in these recent attacks on entrenched conflicts and imbalances, whilst having a greater social and political impact in the retail market than in the wholesale market, are nonetheless equally applicable to the latter.

Moreover, across the global financial services industry regulators have identified certain remuneration practices as major contributors to excessive risk taking, particularly among bank employees. Again, the point of principle – that the way in which a business is rewarded can lead to it being conducted with unacceptable risk and in a socially detrimental manner – is not confined to the financial rewards for individuals: it is equally applicable to the financial rewards for firms. So it is certainly the case that regulatory sentiment is now overtly moving against practices which reinforce or aggravate conflicts of interest.

The results of regulators taking a harder line on conflicts management could greatly reinforce tougher action being taken in other areas, such as the introduction of higher capital requirements. For example, if it is the goal of regulators effectively to force a separation between traditional utility banking activities and proprietary trading, then tougher conflicts rules would readily assist that objective.

The arguments on both sides of that policy debate have been well documented, in particular in the context of discussions in the US around the ‘Volcker Rule’ reform proposal. Critics can point to the risk that if investment banks are to be excluded from accessing short-term deposit funding sources, the effects of any future repetition of the recent liquidity freeze could well be aggravated; and to the flip-side concern that if deposit-taking institutions are unable to provide critical underwriting and advisory services to corporate clients, the result will necessarily be a contraction of the market for such services with resulting weakening of competitive tensions, and concentration of risk, among a core group of investment banking institutions.
How might the FSA use conflicts management as a tool?

The FSA's Handbook contains a general rule that:

“A firm must act honestly, fairly and professionally in accordance with the best interests of its client”.

The FSA's guidance for this rule explains that, in the case of a retail client, a firm will not be in compliance with the rule if it seeks to exclude or restrict any duty or liability (including a fiduciary duty or liability) unless it is “honest, fair and professional for it to do so”.

This rule is expressed in high-level terms, and history shows that standards of honesty, fairness and professionalism can be extremely variable. However, the FSA could easily provide more detailed guidance which, firstly, deleted the narrow reference to dealings with retail clients and, secondly, specified more precisely the FSA's view of the standards required and the likely practical consequences of such standards. Guidance could, for example, provide that:

- there be a presumption against allowing a firm to trade as principal or for the account of its affiliates at a time when it is also dealing on behalf of clients in investments of the same kind, unless specified arrangements amounting to ‘super-Chinese walls’ are in place; or
- a firm should not use fee structures (for example, success fees on a takeover) which might tend to conflict with its duty to offer its client independent advice, this could be achieved by genericising existing rules concerning the remuneration of research analysts held out as independent.

In summary: were regulators to allow, or even encourage, fiduciary duties and liabilities to thrive without modification, many financial services firms could find that existing business models would become unworkable without radical change; such change could tend towards greater simplification of business activities – moving away from the ‘financial supermarket’ model – and a natural separation of client-facing and proprietary trading.

But this distinction between client-facing and proprietary activities may not be so easily made in practice. The distinction has certainly not yet been articulated in clear terms at a political policy level. Unlike advisory services, which are clearly client-facing, other activities that are of equally fundamental importance to the smooth and efficient functioning of markets, such as market-making and the underwriting of securities issues, are arguably neither wholly client-facing nor wholly proprietary in nature. Attempts to enforce a separation between client-facing and proprietary activities could make it difficult and potentially uneconomic for any financial institution to continue to provide these vital support functions. Such action could therefore quite clearly be detrimental for wider national and regional economies.

The FSA's rules on conflicts management derive from the Markets in Financial Instruments Directive (MiFID) and require a firm to identify and manage actual or potential conflicts of interest if the firm or some person connected with the firm:

- is likely to make a financial gain, or avoid a financial loss, at the expense of the client;
- has an interest in the outcome of a service provided to the client or of a transaction carried out on behalf of the client, which is distinct from the client’s interest in that outcome;
- has a financial or other incentive to favour the interest of another client or group of clients over the interests of the client;
- carries on the same business as the client; or
- receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of monies, goods or services, other than the standard commission or fee for that service.
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It is only if a firm’s internal arrangements and controls fail properly to manage such conflicts that customer consent to the existence of the conflict may be used as a ‘management’ tool. In those circumstances, the firm is required to disclose the nature of the conflict to the client who is then to be given the choice of either proceeding with the relevant matter or taking its business elsewhere.

At first sight, the MiFID conflict management rules impose a fairly high standard. However, it should be noted that the onus is on the firm to arrange its business so as to deliver the outcome required by the rules; and this can prove to be the Achilles heel.

What has the FSA said on this topic?

In January 2009, the FSA published the results of its thematic review of firms’ implementation of MiFID requirements, including those relating to the management of conflicts of interest. Significantly, the FSA found that the introduction of the MiFID rules had not led to any noticeable change in the way firms were organising themselves in this area. It appeared then that the industry already felt that it was managing conflicts in a suitable way. However, the FSA noted that the conflicts policies of many firms were “too high level and did not seem to be reflected in practical systems and controls”. There is a hint here that the FSA believed that policy and practice within firms could often diverge.

Having said that, the FSA did not feel minded to adopt a more intrusive approach towards firms’ management of conflicts:

“Given the breadth of firms that the rules cover, we do not believe that it would be useful to give more detail of the specific controls we expect to see in firms; indeed, we recognise that the nature of controls needed depends on the complexity of a firm’s business.”

This could now change if the messages recently coming from the FSA’s senior management are to be believed. In addition to the FSA using its rules to prevent the modification or disapplication of fiduciary duties, the regulator could challenge, or even prescribe, the detail of MiFID conflicts policies by, for example, describing practices which may tend to be to the detriment of clients individually, or perhaps even collectively. In the latter case, invocation of fiduciary duties could otherwise be difficult because of the need for a particular client to show a particular detriment. An example might be the use by a firm of aggregated deal-flow information (‘market colour’), derived from its clients’ dealings, for the benefit of the firm’s own trading strategies, or even, as has apparently happened in the US, selling such information to favoured clients.

Conclusion

Regulators have been concerned by the financial stability risks posed when large firms combine “casino” (largely trading) operations with traditional client-serving operations. It is apparent that regulators across the major financial jurisdictions would like to see separation between the two kinds of activities, to a greater or lesser degree. Moreover, and more recently, regulators have been reviewing and reconsidering the fundamental ethics of the financial sector.

If those regulators are minded to pursue aggressively the objectives of simpler structures and higher standards, then we might expect to see a much tougher approach to conflicts of interest as part of this strategy. This would certainly play to a willing political and public audience.

Whether such action would be to the ultimate benefit of financial institutions, their clients, or the stability of markets more generally, remains to be seen. As noted above, one can foresee unwelcome side effects of regulatory activism in this area. In addition, if fewer institutions are able and willing to provide full-scope

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1 MiFID supervisory priorities – results of wholesale thematic review, FSA, January 2009, paragraph 2.48
investment and banking services then the market for such services will contract; competitive tensions will weaken; liquidity and the availability of funding may be reduced; costs will be likely to increase and therefore also, presumably, transaction fees. This would arguably be bad news for financial institutions and equally bad news for the corporate clients which they serve.

Ultimately, appropriately proportionate reform in this area would require a degree of international co-operation that we suggest is unlikely to be forthcoming, even (perhaps especially) within Europe. The argument can be made that if regulators wish to break down the “financial supermarket” model they could and should do so head on; otherwise, it is the responsibility of the corporate users of investment and banking services, and (in the post-Walker environment) their stakeholders, to regulate the way in which those services are provided, and at what price.