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Conflicts of Interest and Market Discipline Among Financial Service Firms

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Very recent reports on Maxwell Communications Corporation and Enron clearly underlined a single important weakness in the behaviour of corporations and financial markets — the exploitation of conflicts of interest. Although potential conflicts of interest are a fact of life among financial firms, they can only come to flower when competition is not perfect and when markets are not fully transparent. Since underlying market imperfections are systematic even in highly developed financial systems, causing agency problems, it is essential that the problem of conflict-of-interest exploitation is addressed through improved transparency and market discipline if public confidence in financial markets is not to be repeatedly shaken.

This paper explores conflicts of interest in wholesale and retail financial markets, and in financial firms. It reviews existing regulatory measures and rating agencies as well as internal controls, and recommends strengthening of measures to prevent conflict exploitation.

Keywords: Financial conflicts of interest, Financial fraud, Agency costs, Financial market transparency, Financial regulation, Rating agencies, Corporate governance, Chinese walls

In 2001, the UK Department of Trade and Industry (DTI) released its final report on one of the most dramatic British financial scandals in recent memory, the theft of almost $600 million in pension funds belonging to the late Robert Maxwell's Maxwell Communications Corporation and Mirror Group Newspapers PLC.[1] The theft had come to light ten years before, and blame was placed squarely on Robert Maxwell himself (who had apparently committed suicide) and on his son, Kevin. Indeed, the events had vindicated the DTI's own judgment in having censured Maxwell as far back as 1971 as being ''unfit to run a public company.'' What had occurred was criminal – outright larceny and financial fraud. Shocking to many observers was the DTI's conclusion, reached in a deliberate and thoughtful way and carefully phrased with classic British understatement — words like ''cliquishness, greed and amateurism'' and not lightly invoked — that the crime could not have been committed without the active participation of lawyers, accountants and financial intermediaries. Maxwell's accountants (Coopers & Lybrand Deloite) had not noticed the missing pension assets, his law firm and financial adviser (Clifford Chance and Samuel Montagu) suppressed their legal and due diligence judgment to avoid jeopardizing fee income, and his broker-dealer (Goldman Sachs) was cited by the DTI for helping support the Maxwell Communications share price using third parties as a front. Despite a sorry track record and no sign that ''Maxwell had changed his spots,'' all apparently did little more than follow the money.

Shifting across the Atlantic a decade later, we have the final report of the Enron bankruptcy examiner, Neal Batson, released in the summer of 2003 and headlined ''a culture of greed and corruption.''[2] Besides outlining the internal governance failures centered on Enron's management and board, the Batson Report singled-out lawyers, accountants and financial intermediaries without which the then largest bankruptcy in US history could not have occurred. Arthur Andersen was cited for aiding and abetting financial fraud, failures in audit integrity and conflicts of interest, quite apart from the firm's subsequent guilty plea to obstruction of justice charges. Vinson & Elkins, Enron's Houston law firm, was cited for legal advice clouded by business interests. Enron's commercial banks were faulted for lack of credit judgment. But most of all, the investment banks were judged to have created financial vehicles having no commercial purpose, designed solely to misrepresent Enron's financials and deceive investors. According to the Report, they were not merely facilitators, but active initiators and participants

— suppressing their obligations to all other constituencies to extract earnings from the Enron relationship.

Two reports, two decades, two venues, but a single issue – exploitation of conflicts of interest that evidently burst through all of the regulatory, managerial and reputational constraints intended to contain them. How could this happen in two of the most efficient and transparent financial markets in the world? And what does it say about the efficacy of corporate governance, market discipline and external regulation associated with key elements of the financial intermediation process in modern economies?

Potential conflicts of interest are a fact of life among the financial firms that help direct the flow of capital in the market-oriented economy. When those conflicts of interest are exploited, agency costs are imposed on all kinds of users of financial markets, from the smallest retail investor to the largest corporation – sometimes even multiple agency costs. As a result, both efficiency and fairness in financial markets suffer, and so does the effectiveness with which financial intermediaries engage in the corporate monitoring and governance process.

When competition is perfect and when markets are fully transparent, exploitation of conflicts of interest cannot rationally take place. So the necessary and sufficient condition for agency costs attributable to conflicts of interest exploitation requires there to be market and information imperfections. The role of banks, securities firms, insurance companies and asset managers in repeated episodes of conflict-of-interest-exploitation — involving a broad array of abusive market practices, in acting simultaneously as principals and intermediaries, in facilitating various corporate abuses, and in misusing private information – suggests that the underlying market imperfections are systemic even in highly developed financial systems. And the bigger and broader the financial intermediaries, the greater seem to be the agency problems associated with conflict-of-interest exploitation. It follows that efforts to address the issue through improved transparency and market discipline are central to creating viable solutions to a problem that repeatedly seems to shake public confidence in financial markets.

Making Sense of Conflicts of Interest

There are essentially two types of conflicts of interest confronting firms in the financial services industry under market imperfections, which we can segment into two categories. *Type 1 conflicts* may arise between a firm's own economic interests and the interests of its clients, usually reflected in the extraction of economic rents or mispriced transfer of risk. *Type 2 conflicts* may develop between clients, or between different types of clients, which place the firm in a position of favoring one at the expense of another — bankers who systematically favor corporate clients over retail investors in the presence of incomplete information is a prominent example of this type of conflict.

Both types of conflicts can arise either in interprofessional activities carried out in *wholesale* financial markets or in activities involving *retail* clients. The distinction between these two market ''domains'' is important because of the key role of information and transactions costs, which differ dramatically between the two broad types of market participants. Their vulnerability to conflict-exploitation differs accordingly, and measures designed to remedy the problem in one domain may be inappropriate in the other. In addition there are what we shall term ''transition'' conflicts of interest, which run between the two domains — and whose impact can be particularly troublesome. Exhibit 1 enumerates the principal conflicts of interest encountered in financial services firms by *type* and by *domain*.

Conflicts of Interest in Wholesale Financial Markets

In wholesale financial markets involving professional transaction counterparties, corporations and sophisticated institutional investors, the asymmetric information and competitive conditions necessary for conflicts of interest to be exploited are arguably of relatively limited importance. C*aveat emptor* and limited fiduciary obligations rule in a game that all parties fully understand. Nevertheless, several types of conflicts of interest seem to arise.

Principal Transactions
A financial intermediary may be involved as a principal with a stake in a transaction in which it is also serving as adviser, lender or underwriter, creating an incentive to put its own interest ahead of those of its

Wholesale Domain

Type-1 - Firm-client conflicts.
Principal transactions.
Tying.
Misuse of fiduciary role.
Board memberships.
Spinning.
Investor loans.
Self-dealing.
Front-running.

Type-2 - Inter-client conflicts.
Misuse of private information.
Client interest incompatibility.

Retail Domain

Type-1 - Firm-client conflicts.
Biased client advice.
Involuntary cross-selling.
Churning.
Laddering.
Inappropriate margin lending.
Failure to execute.
Misleading disclosure and reporting.
Privacy-related conflicts.

Domain-Transition Conflicts

Type-1 - Firm-client conflicts.
Suitability.
Stuffing.
Conflicted research.
Laddering.
Bankruptcy-risk shifting

Exhibit 1 A Conflict of Interest Taxonomy