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Financial intermediation in the securities markets law and economics of conduct of business regulation

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Abstract

The economic theory explains the role performed by intermediaries in financial markets. In securities markets, in particular, intermediaries act as facilitators of the financial exchange. In this context, conduct of business regulation is justified on the basis of structural problems of asymmetric information affecting the relationship between securities professionals and the individual investor.

In this paper, two major conduct of business rules are analysed in the light of the kind of market imperfections they should be intended to address: the suitability and the anti-churning rules. From a functional perspective, the analysis merges major insights of financial theory with a comparative discussion of the legal rules in both the U.S. and the European Union. Law and economics approach to the matter leads to a much broader and more economically sound interpretation of the "churning" problem. This is related to an agency-based explanation of one of the most topical puzzles under debate in financial economics: the problem of noise trading. © 2000 Elsevier Science Inc. All rights reserved.

Keywords: Churning; Suitability; Noise trading; Securities Regulation

1. Scope of the analysis

The efficiency of financial markets is one of the main matters of concern for economic (and thus legal) policymakers. Efficient allocation of financial resources is the necessary premise for the productive and allocative efficiency of an aggregate (country or world-wide)

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economy. Securities are one of the most important means for the exchange of financial resources. Securities markets, and the role played by financial intermediaries within them, are going to be therefore the subject matter of the present study.[1]

Three major qualifications are required in order to clarify the scope of the analysis. First of all, I am focusing exclusively on the exchange of securities performed in secondary markets. Whereas it is true that efficient allocation of financial resources depends on the efficient performance of the primary market, setting the equilibrium price of newly issued securities, primary markets, however, would presumably not even exist without secondary markets. The key role and function of secondary markets are very well known in financial economics.[2] They basically consist in the marketability of the securities investment and in the evaluation of the same securities through an efficient pricing mechanism. Although it would be interesting, one is not addressing here the problem of the origin and development of organized secondary markets. Simplistic as it may appear, they are taken for granted.

Secondly, by the expression financial intermediaries, I am generally referring to the professional businesses in the securities industry, through which the exchange of securities in secondary markets is ultimately performed by individual investors either directly or indirectly, within the context of dynamic investment management on their behalf. In this sense, the term financial intermediary is mostly used here as a synonym for securities professional. From the economic-functional perspective, that means considering just some, but not all of the functions performed by intermediaries in the financial sector: namely, the exchanging of securities either on behalf of customers or on their own account, the provision of securities investment advice, and the management of securities portfolios.[3] I am neglecting, on the other hand, perhaps the most important function traditionally performed by financial intermediation, that is asset transformation, typically carried out by commercial banks and insurance companies. In legal-institutional terms, I am therefore referring to financial intermediaries whose core business is related to the investment of tradable securities, and specifically to brokers, dealers, investment advisers (including professional asset managers), as well as to the broad category of financial institutions engaged in managing collective investments on behalf of other market participants (i.e., investment companies).[4]

Thirdly, this paper is going to discuss rationales and shortcomings of legal intervention in the market of financial services relating to individuals' investment in securities (hereinafter: "financial investment services," or simply "financial services"). The discussion, however, is exclusively concerned with conduct of business regulation, and thus focuses on how securities professionals deal (i.e., conduct business) with their customers. Prudential regulation, related concerns of financial institutions stability, and possible systemic effects (i.e., externalities) on the financial sector as a whole are therefore not addressed by the present study.[5]

2. Financial intermediation and imperfections in the market for financial services

Financial intermediaries in the securities industry emerge as a response to the failure of spontaneous exchange among investors. This is consistent with common observation. Individual investors never perform the exchange of securities directly, for they are always involved in securities transactions through intermediaries such as broker/dealers, asset