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Conflicts of Interest and Market Discipline Among Financial Services Firms

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Abstract

There has been substantial public and regulatory attention of late to apparent exploitation of conflicts of interest involving financial services firms based on financial market imperfections and asymmetric information. This paper proposes a workable taxonomy of conflicts of interest in financial services firms, and links it to the nature and scope of activities conducted by such firms, including possible compounding of interest-conflicts in multifunctional client relationships. It lays out the conditions that either encourage or constrain exploitation of conflicts of interest, focusing in particular on the role of information asymmetries and market discipline, including the shareholder-impact of litigation and regulatory initiatives. External regulation and market discipline are viewed as both complements and substitutes – market discipline can leverage the impact of external regulatory sanctions, while improving its granularity though detailed management initiatives applied under threat of market discipline. At the same time, market discipline may help obviate the need for some types of external control of conflict of interest exploitation. JEL G21, G24, G28, L14. Keywords: Conflicts of interest. Financial regulation. Financial services. Banking.

Potential conflicts of interest are a fact of life in financial intermediation. Under perfect competition and in the absence of asymmetric information, exploitation of conflicts of interest cannot rationally take place. Consequently, the necessary and sufficient conditions for agency costs associated with conflict of interest exploitation center on market and information imperfections. Arguably, the bigger and broader the financial intermediaries, the greater the agency problems associated with conflict-of-interest exploitation. It follows that efforts to address the issue through improved

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transparency and market discipline are central to creating viable solutions to a problem that repeatedly seems to shake public confidence in financial markets.

In recent years, the role of banks, securities firms, insurance companies and asset managers in alleged conflict-of-interest-exploitation – involving a broad array of abusive retail 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 present even in highly developed financial systems. Certainly the prominence of conflict-of-interest problems so soon after the passage of the US Gramm-Leach-Bliley Act of 1999, which removed some of the key structural barriers to conflict exploitation built into the US regulatory system for some 66 years, seems to have surprised many observers.[1]

Moreover, recent evidence suggests that the collective decision process in the management of major financial firms impairs pinpointing responsible individuals, and that criminal indictment of entire firms runs the risk of adverse systemic effects. Monetary penalties and negotiated settlements neither admitting nor denying guilt seem to have emerged as the principal external mechanisms to address conflict of interest exploitation. Market discipline operating through the share price may, under appropriate corporate governance, represent an important additional line of defense.

Part 1 of this paper proposes a taxonomy of conflicts between the interests of the financial firm's owners and managers and those of its clients, including situations where the firm is confronted by conflicts of interest between individual clients or types of clients. Some of these conflicts have been discussed extensively in the literature,[2] while others seem to have surfaced more recently. Mapped onto this taxonomy is the distinction between conflicts of interest that arise in wholesale and retail domains, characterized by very different degrees of information asymmetry and fiduciary obligations, and conflicts that arise on the interface between the two domains. Part 2 of the paper relates this conflict-of-interest taxonomy to the strategic profile of financial services firms, linking potential conflicts of interest exploitation to the size and breadth of financial firms and illustrating how those conflicts can be compounded in large multi-line financial

institutions. Part 3 reviews regulatory and market discipline-based constraints on conflict-of-interest exploitation, including issues of granularity and immediacy, and considers linkages between the two types of constraints. Part 4 presents the conclusions and some implications for public policy.

1. A Conflict of Interest Taxonomy

There are essentially two types of conflicts of interest confronting firms in the financial services industry under market imperfections.

> *Type 1* - Conflicts between a firm's own economic interests and the interests of its clients, usually reflected in the extraction of rents or mispriced transfer of risk. In addition to direct firm-client conflicts, indirect conflicts of interest could involve collusion between the firm and a fiduciary acting as agent for the ultimate clients.[3]
>
> *Type 2* - Conflicts of interest between a firm's clients, or between types of clients, which place the firm in a position of favoring one at the expense of another.[4]

They may 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. In the following sections, we enumerate the principal conflicts of interest encountered in financial services firms arranged by *type* and by *domain* (see Exhibit 1).

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 clients or trading counterparties. Or the firm may engage in misrepresentation beyond the ability of even highly capable clients to uncover.[5]

Tying. A financial intermediary may use its lending power to influence a client to use its securities or advisory services as well – or the reverse, denying credit to clients that refuse to use other (more profitable) services.[6] Costs are imposed on the client in the form of higher-priced or lower-quality services in an exercise of market power. This differs from cross-subsidization, in which a bank (possibly pressured by clients) engages in lending on concessionary terms in order to be considered for securities or advisory services. There may be good economic reasons for such cross-selling initiatives, whose costs are borne by the bank's own shareholders. The line between tying and cross-selling is often blurred,[7] and its effectiveness is debatable. In 2003 the Federal Reserve helped to clarify the concept of tying, imposing a fine of $3 million on WestLB for violating anti-tying regulations.[8]

Misuse of fiduciary role. Mutual fund managers who are also competing for pension fund mandates from corporations may be hesitant to vote fiduciary shares against the management of those companies, to the possible detriment of their own shareholders. Or the asset management unit of a financial institution may be pressured by a corporate banking client into voting shares in that company for management's position in a contested corporate action such as a proxy battle.[9] The potential gain (or avoidance of loss) in banking business comes at the potential cost of inferior investment performance for the firm's fiduciary clients, and violates its duty of loyalty.[10]

Board interlocks. The presence of bankers on boards of directors of nonfinancial companies may cause various bank functions such as underwriting or equity research to

differ from arms-length practice.[11] This displacement may impose costs on the bank's shareholders[12] or on clients. Although constrained by legal liability issues, director interlocks can compound other potential sources of conflict, such as simultaneous lending, advisory and fiduciary relationships.[13]

Spinning. Securities firms involved in initial public offerings may allocate shares to officers or directors of client firms on the understanding of obtaining future business, creating a transfer of wealth to those individuals at the expense of other investors.[14]

Investor loans. In order to ensure that an underwriting goes well, a bank may make below-market loans to third-party investors on condition that the proceeds are used to purchase securities underwritten by its securities unit.

Self-dealing. A multifunctional financial firm may act as trading counterparty for its own fiduciary clients, as when the firm's asset management unit sells or buys securities for a fiduciary client while its affiliated broker-dealer is on the other side of the trade.[15]

Front-running. Financial firms may exploit institutional, corporate or other wholesale clients by executing proprietary trades in advance of client trades that may move the market.[16]

All of the foregoing represent exploitation of Type 1 conflicts, which set the firm's own interest against those of its clients in wholesale, interprofessional transactions. Type 2 conflicts dealing with differences in the interests of multiple wholesale clients seems to center predominantly on two issues:

Misuse of private information. As a lender, a bank may obtain certain private information about a client. Such proprietary information may be used in ways that harm the interests of the client. For instance, it may be used by the bank's investment banking unit in pricing and distributing securities for another client, or in advising another client in a contested acquisition.[17]

Client interest incompatibility. A financial firm may have a relationship with two or more clients who are themselves in conflict. For example, a firm may be asked to represent the bondholders of a distressed company and subsequently be offered a

mandate to represent a prospective acquirer of that corporation. Or two rival corporate clients may seek to use their leverage to impede each other's competitive strategies. Or firms may underprice IPOs to the detriment of a corporate client in order to create gains for institutional investor clients from whom they hope to obtain future trading business.[18]

Conflicts of Interest in Retail Financial Services

Asymmetric information is intuitively a much more important driver of conflict-of-interest exploitation in retail financial services than in interprofessional wholesale financial markets. Retail issues all appear to involve Type 1 conflicts, setting the interests of the financial firm against those of its clients.

Biased client advice. When financial firms have the power to sell affiliates' products, managers may fail to dispense "dispassionate" advice to clients based on a financial stake in promoting high-margin "house" products. Sales incentives may also encourage promotion of high-margin third-party products, to the ultimate disadvantage of the customer. The incentive structures that underlie such practices are rarely transparent to the retail client.[19] Even when the firm purports to follow a so-called "open architecture" approach to best-in-class product selection, such arrangements normally will be confined to suppliers of financial services with whom it has distribution agreements.

Involuntary cross-selling. Retail clients may be pressured to acquire additional financial services on unfavorable terms in order to access a particular product, such as the purchase of credit insurance tied to consumer or mortgage loans. Or financial firms with discretionary authority over client accounts may substitute more profitable services such as low-interest deposit accounts for less profitable services such as higher-interest money market accounts, without explicit instructions from the client.

Churning. A financial firm that is managing assets for retail or private clients may exploit its agency relationship by engaging in excessive trading, which creates higher costs and may lead to portfolio suboptimization. Commission-based compensation is the usual cause of churning, which can also arise in institutional portfolios – average

US equity mutual fund turnover rose from 17% annually in the 1950s to almost 110% in the early 2000s.[20]

Inappropriate margin lending. Clients may be encouraged to leverage their investment positions through margin loans from the firm, exposing them to potentially unsuitable levels of market risk and high credit costs. Broker incentives tied to stock margining usually underlie exploitation of this conflict of interest.

Failure to execute. Financial firms may fail to follow client instructions on market transactions if doing so benefits the firm. Or payments may be delayed to increase the float.[21]

Misleading disclosure and reporting. Financial firms may be reluctant to report unfavorable investment performance to clients if doing so threatens to induce outflows of assets under management. Whereas a certain degree of puffery in asset management performance reviews is normal and expected, there is undoubtedly a "break-point" where it becomes exploitive if not fraudulent.

Violation of privacy. The complete and efficient use of internal information is central to the operation of financial services firms, including such functions as cross-selling and risk assessment. This may impinge on client privacy concerns or regulatory constraints on misuse of personal information, and raises conflict-of-interest issues that tend to be increasingly serious as the activity-lines of a particular firm become broader.[22]

Wholesale-Retail Conflicts

Conflicts of interest between the *wholesale* and *retail* domains – characterized by very different information asymmetries – can be either Type 1 or Type 2, and sometimes both at the same time.

Suitability. A classic domain-transition conflict of interest exists between a firm's "promotional role" in raising capital for clients in the financial markets and its obligation to provide suitable investments for retail clients. Since the bulk of a firm's earnings usually come from capital-raising side, and given the information asymmetries that exist, exploiting such conflicts can have adverse consequences for retail investors.

Stuffing. A financial firm that is acting as an underwriter and is unable to place the securities in a public offering may seek to ameliorate its exposure to loss by allocating unwanted securities to accounts over which it has discretionary authority. [Schotland, 1980] This conflict of interest is unlikely to be exploited in the case of closely-monitored institutional portfolios in the wholesale domain. But in the absence of effective legal and regulatory safeguards, it could be a problem in the case of discretionary trust accounts in the retail domain.

Conflicted research. Analysts working for multifunctional financial firms wear several hats and are subject to multiple conflicts of interest. In such firms, the researcher may be required to: (1) Provide unbiased information and interpretation to investors, both directly and through retail brokers and institutional sales forces; (2) Assist in raising capital for clients in the securities origination and distribution process; (3) Help in soliciting and supporting financial and strategic advisory activities centered in corporate finance departments; and (4) Support various management and proprietary functions of the firm. These diverse roles are fundamentally incompatible, and raise intractable agency problems at the level of the individual analyst, the research function, the business unit, and the financial firm as a whole. The extent of this incompatibility has been reflected, for example, in the post-IPO performance of recommended stocks [Michaely & Womack, 1999], contradictory internal communications released in connection with regulatory investigations, evidence on researcher compensation, and the underlying economics of the equity research function in securities firms.[23] Other evidence seems to suggest that efforts to exploit this conflict of interest are generally unsuccessful in terms of investment banking market share and profitability. [Ljungqvist et al., 2003]

It is argued that equity research conflicts are among the most intractable. Researchers cannot serve the interests of buyers and sellers at the same time. No matter how strong the firewalls, as long as research is not profitable purely on the basis of the buy-side (e.g., by subscription or pay-per-view), the conflict can only be constrained but never eliminated as long as sell-side functions are carried out by the same organization. And even if research is purchased from independent organizations, those organizations

could face the same inherent conflicts if they expect to develop further business commissioned by their financial intermediary clients.[24]

Market-timing and late-trading. Important clients tend to receive better service than others, in the financial services sector as in most others. When such discrimination materially damages one client segment to benefit another, however, a conflict of interest threshold may be breached and the financial firm's actions may be considered unethical or possibly illegal, with potentially serious consequences for the value of its franchise. Such cases came to light in 2003, involving both criminal fraud charges and civil settlements regarding "late trading" and "market timing" by hedge funds in the shares of mutual funds, shifting returns from ordinary investors to the hedge funds in exchange for other business solicited by the mutual fund managers involved.[25]

Laddering. Banks involved in initial public offerings may allocate shares to institutional investors who agree to purchase additional shares in the secondary market, thereby promoting artificial prices intended to attract additional (usually retail) buyers who are unaware of these private commitments.[26] A related conflict involves providing bank loans to support the price of a security in the aftermarket. [Saunders, 1995]

Shifting bankruptcy risk. A bank with credit exposure to a client whose bankruptcy risk has increased, to the private knowledge of the banker, may have an incentive to assist the corporation in issuing bonds or equities to the general public, with the proceeds used to pay-down the bank debt.[27] Such behavior can also serve to redistribute wealth between different classes of bondholders and equity investors, and represents one of the "classic" conflicts of interest targeted by the 1933 separation of commercial and investment banking in the United States.

2. Conflicts of Interest and Strategic Profiles of Financial Firms

We posit that the broader the activity-range of financial firms in the presence of imperfect information, (1) the greater the likelihood that the firm will encounter potential conflicts of interest, (2) the higher will be the potential agency costs facing clients, and (3) the more difficult and costly will be the internal and external safeguards necessary to

prevent conflict exploitation. If true, competitive consequences associated with conflict-exploitation can offset the realization of economies of scope in financial services firms. Scope economies are intended to generate benefits on the demand side through cross-selling (revenue synergies) and on the supply side through more efficient use of the firm's business infrastructure (cost synergies). As a result of conflict exploitation the firm may initially enjoy revenue and profitability gains at the expense of clients. Subsequent adverse legal, regulatory and reputational consequences – along with the managerial and operational cost of complexity – can be considered diseconomies of scope.

The potential for conflict-of-interest exploitation in financial firms can be depicted in a matrix such as Exhibit 2. The matrix lists on each axis the main types of retail and wholesale financial services, as well as infrastructure services such as clearance, settlement and custody. Cells in the matrix represent potential conflicts of interest. Some of these conflicts are basically intractable, and remediation may require changes in organizational structure. Others can be managed by appropriate changes in incentives, functional separation of business lines, or internal compliance initiatives. Still others may not be sufficiently serious to worry about. And in some cases it is difficult to imagine conflicts of interest arising at all.

For example, in Exhibit 2 cell D is unlikely to encompass activities that pose serious conflicts of interest. Others cells, such as C, have traditionally been ring-fenced using internal compliance systems. Still others such as B and E can be handled by assuring adequate transparency. But there are some, such as A, which have created major difficulties in particular circumstances (such as advising on a hostile takeover when the target is a banking client), and for which easy answers seem elusive.

Potential Conflicts of Interest in Multifunctional Client Relationships

The foregoing discussion suggests that conflicts of interest are essentially two-dimensional – either between the interests of the firm and those of its client (Type 1), or between clients in conflict with one another (Type 2). They can also be multidimensional, however, spanning a number of different stakeholders and conflicts at the same time.

Exhibits 3 and 4 provide two examples from the rich array of corporate scandals that emerged during 2001-2003.

In the Merrill Lynch - Enron case (Exhibit 3), a broker-dealer was actively involved in structuring and financing an off-balance-sheet special-purpose entity (LJM2), which conducted energy trades with Enron and whose CEO was simultaneously Enron's CFO. Merrill was both a lender to and an investor in LJM2 – as were a number of senior Merrill executives and unaffiliated private and institutional investors advised by the firm. Merrill also structured a repurchase transaction for Enron involving a number of barges in Nigeria. Allegedly, the sole purpose of the highly profitable LJM2 and Nigerian barge transactions was to misrepresent Enron's financials to the market.[28]

At the same time, Merrill performed a range of advisory and underwriting services for Enron, provided equity analyst coverage, and was one of Enron's principal derivatives trading counterparties. Conflicts of interest in this case involved Merrill and Enron shareholders, investors in Enron and LJM2 debt, Merrill executives, as well as unaffiliated institutional and private shareholders in the LJM2 limited partnership.

Such structures were instrumental in Enron's 2001 Chapter 11 bankruptcy filing, with pre-petition on- and off-balance sheet liabilities exceeding $60 billion. [Batson, 2003b] As a consequence, the financial firms that helped design and execute them (and in some cases actively marketed them to other clients) have been in the regulatory spotlight. In July 2003 JP Morgan Chase and Citigroup agreed to pay $192.5 million and $126.5 million, respectively, in fines and penalties (without admitting or denying guilt) to settle SEC and Manhattan District Attorney charges of financial fraud, which in turn encouraged civil suits and risked some of the banks' Enron loans with "equitable subordination" in the Enron bankruptcy proceedings.[29]

In the Citigroup - WorldCom case (Exhibit 4), a global financial conglomerate was serving simultaneously as equity analyst supplying assessments of WorldCom to institutional and (through the firm's brokers) retail clients while advising WorldCom management on strategic and financial matters, at times participating in board meetings. As a major telecommunications-sector commercial and investment banking client,

WorldCom maintained an active credit relationship with Citigroup and provided substantial securities underwriting business. Citigroup also served as the exclusive pension fund adviser to WorldCom and executed significant stock option trades for WorldCom executives as the options vested (having also advised them to reinvest dividends in WorldCom shares), while at the same time conducting proprietary trading in WorldCom stock. Simultaneous conflict of interest vectors in this instance relate to retail investors, institutional fund managers, WorldCom executives, and WorldCom shareholders as well as Citigroup's own positions in WorldCom lending exposure and stock trades prior to its $103 billion (pre-petition liabilities) bankruptcy in 2002.

Such examples suggest that the broader the range of services that a financial firm provides to an individual client in the market, the greater the possibility that conflicts of interest will be compounded in any given case, and (arguably) the more likely they are to damage the market value of the financial firm's business franchise once they come to light.

3. Constraining Exploitation of Conflicts of Interest

From a public policy perspective, efforts to address exploitation of conflicts of interest in the financial services sector should logically focus on improving market efficiency and transparency. Compelling arguments have been made that regulation can materially improve the efficiency of financial systems. The greater the information asymmetries and transaction-cost inefficiencies that exist (inefficiencies that are at the core of the conflict-of-interest issue), the greater is the potential gain from regulation that addresses these inefficiencies. [Kane, 1987] In the United States, periodic efforts in this direction go back almost a century, often in response to perceived market abuses. A recent example is SEC Regulation FD ("fair disclosure") of 1999, governing the flow of corporate information to the financial markets, with a clear potential for ameliorating certain conflicts of interest.

Nonetheless, the history of US and other relatively well-developed financial markets chronicles a litany of conflict-of-interest exploitation involving all of the major-

bracket US securities firms, four of the top-six UK merchant banks (prior to their acquisition by larger financial firms), all of the major Japanese securities houses, as well as various commercial banks, asset managers, insurance companies and financial conglomerates.[30] So what is left of market imperfections and information asymmetries, even under intense competition and regulatory oversight, appears to allow plenty of scope for persistent conflict exploitation on the part of financial intermediaries. It suggests a continuing role for external control through firm-specific regulation and market discipline and internal control through improved corporate governance, incentive structures, and compliance initiatives.

Regulation-Based Constraints

The regulatory overlay of the financial services sector can be conveniently depicted in terms such as Exhibit 5. The right-hand side of the diagram identifies the classic policy tradeoffs that confront the design and implementation of a properly structured financial system. On the one hand, financial regulation must strive to achieve maximum static and dynamic efficiency. This implies low levels regulation consistent with a competitive market structure, creating sustained pressure on financial intermediaries to achieve operating cost and revenue efficiencies, and to innovate. On the other hand, regulation must safeguard the stability of, and confidence in, the financial system and its institutions. Safety-net design is subject to well-known difficulties such as moral hazard and adverse selection, and can become especially problematic when different types of financial services shade into each other, when on- and off-balance sheet activities are involved, when some of the regulated firms are multifunctional financial conglomerates, and when business is conducted across national and functional regulatory regimes and may exploit “fault lines” between them.

Regulators continuously face the possibility that “inadequate” regulation will result in costly failures, on the one hand, and on the other hand the possibility that “overregulation” will create opportunity costs in the form of financial efficiencies not achieved (which by definition cannot be measured). Since any improvements in financial

stability can only be calibrated in terms of damage *that did not occur* and external costs that were successfully *avoided*, the argumentation surrounding financial regulation is invariably based on "what if" hypotheticals. In effect, regulators face the daunting task of balancing the unmeasurable against the unknowable.

The principal tools depicted in Exhibit 5 that regulators have at their disposal include (1) "Fitness and properness" criteria, under which a financial institution are chartered and allowed to operate, (2) Frequency and speed of financial reporting, (3) Line-of-business regulation as to what types activities financial institutions may engage in, (4) Adequacy of capital and liquidity, (5) Limits on various types of exposures, and (6) Rules governing valuation of assets and liabilities. But regulatory initiatives can easily create financial market distortions of their own, which can become problematic when financial products and processes evolve rapidly and the regulator can easily get one or two steps behind.

A third issue depicted in Exhibit 5 involves the regulatory machinery itself, including self-regulatory organizations (SROs) and public oversight by regulators with civil and criminal enforcement powers. The proper role of SROs is often debated, especially when there are clear abuses in financial markets.[31] "Regulatory capture" is a perennial problem with SROs, suggesting greater reliance on public-oversight for financial regulation. But this too is subject to regulatory capture, since virtually any regulatory initiative is likely to confront powerful vested interests attempting to bend the rules in their favor [Kane, 1987; White, 1991].

Further tradeoffs are encountered between regulatory and supervisory alternatives. Some regulatory techniques (for example, capital adequacy rules) are fairly easy to supervise but full of distortive potential given to their broad-gauge nature. Others (for example, fitness and properness criteria) may be cost-effective but difficult to supervise. Some supervisory techniques involve higher compliance costs than others. Regulators must deal with these tradeoffs under conditions of ongoing market and industry change, blurred institutional and activity demarcations, and functional as well as cross-border regulatory fault-lines.

Within this setting, regulatory control of conflicts of interest tends to be applied through both SROs and public agencies, and is generally anchored in banking, insurance, securities, and consumer protection legislation that is supposed to govern market practices. Its failure to prevent serious exploitation of conflicts of interest came into particularly sharp relief in the US during the early 2000s with serial revelations of misconduct by financial intermediaries. Most of the regulatory initiatives in these cases were taken not by the responsible SROs or by the national regulators, but by the New York State Attorney General under the Martin Act, a 1921 state law which was aimed at securities fraud, survived all subsequent banking and securities legislation, and was bolstered in 1955 with criminal penalties.[32] The *de facto* ceding of enforcement actions by the SROs and the SEC to a state prosecutor (later joined by several others) focused attention on gaps in external regulation and led to a burst of activity by the SEC, the NYSE, the NASD, and the Congress, including the 2002 Sarbanes-Oxley legislation and the 2003 $1.4 billion "Global Settlement" with 12 major banks and securities firms.

Both the Martin Act prosecutions and the Sarbanes-Oxley legislation appear flawed. The "Global Settlement" allowed financial firms to settle without determination of guilt or innocence, thereby creating no new legal ground.[33] The Sarbanes-Oxley Act was drafted in haste and quickly triggered unintended consequences, including international regulatory repercussions and extraordinarily high compliance costs for financial intermediaries and their clients.

Market-Discipline Constraints

If external regulatory constraints on conflict-of-interest exploitation are frequently politicized and difficult to devise, calibrate and bring to bear on specific problems without collateral damage, what is the alternative? As a general matter, it can be argued that regulatory constraints and litigation are relatively blunt instruments in dealing with exploitation of conflicts of interest in financial firms, conflicts that are often extremely granular and sometimes involve conduct that is "inappropriate" or "unethical" rather than "illegal." So the impact of conflict exploitation on the market value of a financial firm

may provide a more consistent, incentive-compatible and durable basis for firm-specific, internal defenses against exploitation of conflicts of interest. Here we shall argue that constraints on conflicts of interest that are rooted in market discipline can be substantially more cost-effective and surgical than constraints based on external regulation. Given the persistence of market inefficiencies and information asymmetries they can, acting in combination, have powerful deterrent effects on conflict of interest exploitation.

Revenues. Exploitation of conflicts of interest, whether or not they violate legal and regulatory constraints, can have a powerful reputation effect, leading to revenue erosion as clients defect to competitors. In the case of Bankers Trust's 1995 exploitation of conflicts of interest in derivatives trading with Procter & Gamble Inc. and Gibson Greetings Inc., revenue losses from client defections dwarfed the $300 million in customer restitution the firm was forced to pay. It left the firm mortally wounded, subsequently to be acquired by Deutsche Bank AG in 1999. In the case of conflict-of-interest exploitation at Arthur Andersen in 2002, reputation losses and client defections virtually assured the liquidation of the firm well before its indictment and conviction on criminal charges

Costs. Increased regulatory pressure and market-impacts of conflict exploitation can jointly force the creation of a robust compliance infrastructure and other managerial safeguards that may reduce operating efficiency. This includes organizational changes and separation of functions that may impair realization of revenue economies of scope. Compliance itself is an expensive business in terms of direct outlays as well as separation of business units by "Chinese walls" or into distinct legal entities, which can erode operating efficiency. Also on the cost side is the impact of regulatory penalties in civil and criminal litigation and class action settlements.[34]

Risks. The likelihood of exploitation of conflicts of interest and its consequences clearly is incorporated in the valuation of financial firms in the marketplace. A high degree of sensitivity to conflict exploitation and its revenue and cost impacts should be associated with greater earnings volatility and a lower share price, all else equal.

How these three factors may come together to damage a firm's market value can be illustrated by a 1993 case, depicted in Exhibit 6, in which J.P. Morgan simultaneously acted as commercial banker, investment banker, and adviser to Banco Español de Crédito (Banesto) in Spain, as well as serving as an equity investor and fund manager for co-investors in a limited partnership (the Corsair Fund, L.P.) holding shares in the firm. Additionally, Morgan's Vice Chairman served on Banesto's Supervisory Board. The potential conflicts of interest imbedded in the complex relationship may have affected the Morgan stock price immediately after the Bank of Spain, concerned about a possible Banesto collapse, announced a takeover of the bank on December 28, 1993.[35] Abnormal returns attributable to the Banesto event for JP Morgan shareholders represented a cumulative loss of about 10% of the market value of equity at the time, a drop in JP Morgan market capitalization of approximately $1.5 billion as against a maximum direct after-tax loss of about $10 million. [DeLong and Walter 1993]. This is consistent with the findings of an earlier event study by Smith [1992] of the Salomon Brothers Treasury bond auction scandal in 1991, which was associated with a one-third share price drop and contributed to Salomon's ultimate absorption by Travelers, Inc.[36]

Another set of market-based constraints on the exploitation of conflicts of interest relies on the negotiation of improved contracts between financial intermediaries and their clients. Examples include broker compensation not based on commissions, IFA fees paid directly by clients, and IPO underwriting compensation that is sensitive to the issuer's valuation.[37]

Intersection of Regulation and Market-Based Constraints

One can therefore argue that regulation-based and market-based *external* controls, through the corporate governance process, create the basis for *internal* controls which can be either *prohibitive* (as reflected in Chinese walls and compliance systems, for example) or *affirmative*, involving the behavioral "tone" and incentives set by senior management together with reliance on the loyalty and professional conduct of employees. The more complex the financial services organization – perhaps most dramatically in the case of

global financial services conglomerates, where comprehensive regulatory insight is implausible – the greater the challenge of sensible conflict-of-interest regulation, suggesting greater reliance on the role of market discipline. The logic runs as follows:

First, market discipline can leverage the effectiveness of regulatory actions.[38] When they are announced -- and especially when they are amplified through aggressive investigative reporting by independent media -- regulatory actions can have a serious adverse effect on a financial firm's share price as well as its debt rating. In turn, this affects its cost of capital, its ability to make strategic acquisitions, its vulnerability to takeover, and management compensation. Such effects simply reflect the market's response to the prospective impact of regulatory actions on revenues, costs (including derivative civil litigation) and exposure to risk.[39] Assuming appropriate corporate governance, boards and managements should be sensitive both to regulatory constraints and prospective market-reactions with regard to exploitation of conflicts of interest. That is, they should be aware that violations of regulatory constraints designed to limit conflict-of-interest exploitation may be greatly amplified by market reactions – in the extreme including absorption by other firms, breakup, or bankruptcy.[40] This awareness ought to be reflected in compensation arrangements as well as in the firm's organizational structure.

Second, even in the absence of explicit legal or regulatory constraints, actions that are widely considered to be "unfair" or "unethical" or that otherwise violate accepted behavioral norms will tend to trigger market discipline. In a competitive context, this will affect firm valuation through the revenue and risk dimensions in particular. Avoiding conflict of interest exploitation is likely to reinforce the value of the firm as a going concern and, with properly structured incentives, management's own compensation. In a firm well known for tying managers' remuneration closely to the share price, Citigroup CEO Sanford Weill in 2002 noted in a message to employees "There are industry practices that we should all be concerned about, and although we have found nothing illegal, looking back, we can see that certain of our activities do not reflect the way we believe business should be done. That should never be the case, and I'm sorry for that."[41]

Third, since they tend to be more granular and provide constant reinforcement in metrics that managers can understand (market share, profitability, and the stock price) market discipline constraints can reach the more opaque areas of conflict-of-interest exploitation, and deal with those issues as they occur in real time, which external regulation normally cannot do.

Fourth, since external regulation bearing on conflicts of interest tends to be linked to information asymmetries and transaction costs, it should logically differentiate between the wholesale and retail domains, discussed earlier. Often this is not feasible, resulting in overregulation in some areas and underregulation in others. Market discipline-based constraints can help alleviate this problem by permitting lower overall levels of regulation and bridging fault-lines between wholesale and retain financial market domains. Few things are as reputation-sensitive as hawking the "risk-free" rump-ends of structured asset-backed securities deals -- so-called "toxic waste" -- to retirees in trailer homes trying to make ends meet. Moreover, just as market discipline can reinforce the effectiveness of regulation, it can also serve as a precursor of sensible regulatory change.

Finally, market structure and competition between strategic groups of financial firms can help reinforce the effectiveness of market discipline. For example, private information accessible to a bank as lender to a corporate acquisition target would almost certainly preclude its affiliated investment banking unit from acting as an adviser to a potential acquirer. An entrepreneur may not want his or her private banking affairs handled by a bank that also controls his or her business financing. A broker may be encouraged by a firm's compensation arrangements to sell in-house mutual funds or externally-managed funds with high fees under "revenue-sharing" arrangements, as opposed to funds that would better suit the client's needs.[42] Market discipline that helps avoid exploitation of such conflicts may be weakened if most of the competition is coming from a monoculture of similarly-structured firms which face precisely the same issues. But if the playing field is also populated by a mixed bag of aggressive insurance companies, commercial banks, thrifts, broker-dealers, fund managers, and other

"monoline" specialists, market discipline may be much more effective – assuming competitors can break through the fog of asymmetric information.

Conclusions

Based on a taxonomy of potential conflicts of interest in financial services firms, how these conflicts relate to their strategic positioning, and the conditions that underlie their exploitation, we conclude that market discipline -- though the reputation-effects on the franchise value of financial intermediaries -- can be a powerful complement to and potential substitute for external regulation.

Firms can benefit from conflict-exploitation in the short term, to the extent that business volumes and/or margins are increased as a result. On the other hand, reputation losses associated with conflict-exploitation can cause serious damage, as demonstrated by repeated "accidents," and contribute to weaker market valuations among the most exposed financial services firms. The fact that such events repeat with some regularity suggests that market discipline is no panacea – for reasons that include lapses in corporate governance among financial services firms themselves.

In the end, management of such firms must be convinced that a good defense is as important as a good offense in determining sustainable competitive performance. This is something that is extraordinarily difficult to put into practice in a ruthlessly competitive environment, and seems to require an unusual degree of senior management leadership and commitment. [Smith and Walter, 1997] Internally, there have to be mechanisms that reinforce the loyalty and professional conduct of employees -- conflict management is a costly and complicated (non-revenue-generating) business, quite apart from the various types of walls between business units and functions that inhibit efficient use of proprietary information. Externally, there has to be careful and sustained management attention to reputation and competition as disciplinary mechanisms.

Market discipline is an often-overlooked sanction. It greatly reinforces regulatory mechanisms, particularly when there are too-big-to-fail considerations and constraints on criminal prosecution. In turn, it relies on a favorable legal framework, including

controversial elements such as the Martin Act and class action litigation. Alongside measures to improve transparency and market efficiency, an important public policy objective is to make market discipline more effective, notably through better corporate governance and internal reward systems more closely aligned to the interests of shareholders. Still, “accidents” will continue to happen, sometimes repeatedly and sometimes repeatedly within the same firm. There is no panacea. Nirvana is too expensive.

Endnotes

[1] Public accounting firms and law firms have been the subject of serious conflict of interest allegations as well, but are considered here as part of the market infrastructure, as opposed to serving as direct participants in the financial intermediation function.

[2]See for example Edwards [1979], Saunders [1985], and Rajan [1996]. A general survey of the literature on corporate conflicts of interest is presented by Demski [2003].

[3] An example would be collusion between financial firms and pension trustees to the ultimate detriment of pension beneficiaries. Cases involving Orange County, California derivatives exposures and "pay to play" municipal bond scandals involving the State of Massachusetts come to mind. See Smith and Walter [1997] Here the solutions would seem to involve writing better contracts between the clients and their agents through reform of state and local political processes.

[4]Firm behavior that systematically favors corporate clients over retail investors in the presence of asymmetric information is a prominent example of this type of conflict.

[5] The classic case involves complex Bankers Trust's derivative transactions with Procter & Gamble Inc. and Gibson Greetings Inc. in 1995, which triggered major damage to the Bank's franchise, key executive changes, and made the Bank a takeover target..

[6]A 2002 survey of corporations with more than $1 billion in annual sales found that 56% of firms that refused to buy fee-based bank services had their credit restricted or lending terms altered adversely, and 83% of the surveyed CFOs expected adverse consequences should they refuse to buy non-credit services. [Association for Financial Professionals, 2003].

[7]In the United States the first type of linkage is prohibited under the anti-tying provisions of the Bank Holding Company Act Amendments of 1970 and by the Federal Deposit Insurance Act, while reducing the price of credit to benefit an investment banking affiliate violates Section 23B of the Federal Reserve Act. However, the courts have generally upheld allegations of tying only where abuse of market power has been demonstrated. Since anti-trust cases in wholesale banking are difficult to make in light of the industry's competitive structure, very few allegations of tying have been found to violate the law. Tying can also have some perverse competitive consequences. [Stefanadis , 2003] There are no prohibitions on tying bank lending to trust services, deposit balances, etc. and investment banks are in any case exempt from anti-tying constraints and have actively used senior debt to obtain fee-based business. For a review, see Litan [2003].

[8]Banks may not use their lending power "in a coercive manner" to sell non-lending services, although they may link lending and non-lending services when clients seek such "bundling." Even so, they cannot tie a given loan to a given non-lending product without allowing the client "meaningful choice." In the WestLB case, the bank required participation in debt underwriting as a condition of lending in a series of structured finance transactions. See "Fed Fines WestLB $3m for 'Tying' Loans to Products," *Financial Times*, August 28, 2008.

[9]Example: The 2001-02 Hewlett-Packard Co. effort to acquire Compaq Computer Corp. was bitterly opposed by the son of one of the co-founders, William R. Hewlett. Hewlett assembled sufficient backing to force the contest down to the wire. H-P began to lobby one of the large institutional shareholders – the

investment arm of Deutsche Bank AG, which had opposed the merger – to change its vote. Other Deutsche Bank units, notably the corporate finance division, favored H-P in the merger. But the Chinese wall between the dealmakers and the asset managers apparently held firm. Shortly before the proxy vote, H-P CEO Carly Fiorina was quoted as saying "...we need a definite answer from the [Deutsche Bank] Vice Chairman, and if it's the wrong one, we need to swing into action.... See what we can get, but we may have to do something extraordinary to bring them over the line here." [Burrows, 2003] Deutsche then set up meetings with both H-P and Walter Hewlett and, after some heated internal debate, changed its votes in favor of H-P. The vote-switch, along with a similar story at Northern Trust Co., was investigated by the SEC and the US Attorney's Office for the Southern District of New York. The SEC fined Deutsche Bank $570,000 in July 2003 for not disclosing its conflict of interest in the matter. See Deborah Solomon and Pui-Wing Tam, "Deutsche Bank Unit is Fined Over H-P," *Wall Street Journal*, August 19, 2003.

[10]In a very different example, prior to WorldCom's 2002 bankruptcy filing the investment banking unit of Citigroup was the lead advisor and banker to the firm. Citigroup also served as the exclusive administrator of the WorldCom executive stock option plan. Executive stock options were generally exercised early in January, and the firm's fund administrators allegedly passed information on their size and timing to Citigroup's equity trading desk, allowing traders to front-run the WorldCom executives' transactions. [Morgenson, 2001]

[11]A high-profile case emerged in 2002, when a member of the ATT Board, Citigroup Chairman and CEO Sanford Weil allegedly urged the firm's telecom analyst, Jack Grubman, to rethink his negative views on the company's stock – ATT CEO Michael Armstrong also served on the Citigroup Board. ATT shares were subsequently up-rated by Grubman, and Citigroup coincidentally was mandated to co-manage an issue of ATT Wireless tracking stock. Grubman down-rated ATT again not long thereafter, and Weill himself narrowly averted being named in subsequent regulatory investigations of the case. See Schiesel and Morgenson [2002].

[12]For shareholders these costs in the United States could come through the legal doctrines of "equitable subordination" and "lender liability" in case of financial distress, which must be offset against the relationship-related and private-information benefits that board membership may contribute. This is given as a reason why bankers tend to be present mainly on the boards of large, stable corporations with low bankruptcy risk. [Krozner and Strahan, 1999]

[13]For example, of the ten largest US nonfinancial corporations (by market capitalization) in 2002, 7 had senior bankers or former bank CEOs on their boards in 2002. [Corporate Library, 2003].

[14]In the literature, see Ritter and Welch [2002]; Loughran and Ritter [2002].

[15]The 1974 Employee Retirement Income Security Act (ERISA) in the US bars transactions between asset management units of financial firms that are fiduciaries for defined-benefit pension plans and affiliated broker-dealers, despite possible costs in terms of best-execution. [Saunders et al., 2001] Trades between US mutual funds and affiliated securities units of the fund management firm must be fully disclosed.

[16]Example: In April 2003 investigations by the SEC and the NYSE were aimed at floor specialists allegedly violating their "negative obligation" or "affirmative obligation" in assuring fair and orderly markets in listed securities, and instead "trading ahead" of customer orders. Included in the 2003 investigation were specialist affiliates of major financial firms including FleetBoston Financial Group, Goldman Sachs Group and Bear Stearns Cos. [Kelly and Craig, 2003] All were heavily fined by the NYSE in October 2003. Criminal front-running charges had previously been filed by the NASD in 1998 against Spear, Leeds & Kellogg (prior to its acquisition by Goldman Sachs) by the NASD for intentionally delayed trade reporting

and was again fine in 2003 by the American Stock Exchange for trading misconduct during the years 1999-2002.

[17]Examples: In 2003 Dana Corp. sued to prevent UBS from advising on a hostile bid by ArvinMeritor Corp. on grounds of "breach of duty" and "breach of contract" due to the bank's relationship with Dana. UBS argued that its ArvinMeritor relationship predated its relationship with Dana, which in any case was non-exclusive. See "UBS Sued Over Role in Bitter Battle," *Financial Times*, August 6, 2003. In a classic case that emerged in 1988, Sterling Drug Company was the object of a hostile takeover bid by F. Hoffmann La Roche of Switzerland, advised at the time by J.P. Morgan, which also had a banking relationship with Sterling. During the three-week battle, Sterling blasted Morgan for providing investment banking services to Roche. CEO John M. Pietruski sent a letter to Morgan Chairman Lewis T. Preston indicating that he was shocked and dismayed by what he considered to be Morgan's unethical conduct in aiding and abetting a surprise raid on one of its longtime clients. Morgan, he suggested, was "privy to our most confidential financial information," including shareholder lists, and asked "How many relationships of trust and confidence do you have to have with a client before you consider not embarking on a course of action that could be detrimental to [its] best interest?" The Sterling chairman said his company was reviewing "all our dealings" with Morgan, and intended to "bring the matter to the attention" of other Morgan clients. See "A Picture Perfect Rescue," *Time*, February 1, 1988.

[18]In 2003 revelations, some investor clients (mainly hedge funds) appear to have kicked-back a significant part of their IPO gains to the underwriting firms in the form of excessive commissions on unrelated secondary market trades. [Attorney General of the State of New York, 2003].

[19]Following SEC, NASD and Massachusetts securities regulators investigations of its mutual fund sales practices, civil charges were settled in September 2003 by Morgan Stanley in connection with the use of sales contests to sell in-house back-end loaded funds -- in direct violation of 1999 rules barring such practices. The firm was fined $2 million in the matter. See "Morgan Stanley to Face Charges Over Contest," *Wall Street Journal*, August 11, 2003; and "Morgan Stanley Fined Over Mutual Funds," *Financial Times*, September 17, 2003.

[20]John C. Bogle, "Mutual Fund Directors: The Dog That Didn't Bark," *Vanguard*, January 28, 2001.

[21]The brokerage firm of E.F. Hutton was criminally indicted for check kiting in 1985, and subsequently was absorbed by Shearson Lehman Bros. Regulatory enforcement in the brokerage industry tightly circumscribes failure to execute.

[22] The 1999 Gramm-Leach-Bliley Act eliminating functional barriers for US financial services firms contains privacy safeguards with respect to sharing personal information with outside firms, but not intra-firm sharing among banking, brokerage, asset management and insurance affiliates. The Fair Credit Reporting Act of 1970 (as amended in 1996) allows sharing of certain data within multifunctional financial firms. This issue is complicated in the US by state blue-sky laws versus federal authority, "opt-in" versus "opt-out" alternatives with respect to client actions, the need to track credit histories, and efforts to combat identity theft.

[23] Firms argue, for instance, that expensive research functions cannot be paid for by attracting investor deal-flow and brokerage commissions, so that corporate finance and other functions must cover much of the cost. Moreover, researcher compensation levels -- far in excess of anything that could possibly be explained by incremental buy-side revenues at prevailing highly competitive commission rates -- provide inferential evidence for the agency problems involved.

[24] There is some evidence that high-quality buy-side equity research is increasingly to be found in small, sector-specialized boutiques, and that institutional investors are willing to pay hard money for that research. If this business model proves to be viable, and if brokers are willing to source the same research for their retail clients, it could provide to be a useful-market-based approach to the conflicted research problem.

[25] One hedge fund reached a $40 million settlement with the New York State Attorney General, basically a disgorgement of illicit profits from "late trading" in shares of mutual funds managed by Bank of America, Strong Capital Management, BancOne, Janus Capital Group, Prudential Securities and Alliance Capital Management (AXA Financial) – altogether representing 287 mutual funds with $227 billion in assets under management. Late trading allowed the hedge fund to execute trades at 4 pm daily closing net asset values (NAV) as late as 9 pm, enabling the hedge fund to profit from news released during the interval. Other fund investors were obliged to trade at the opening NAV on the following day. The practice transferred wealth from ordinary shareholders to the hedge fund in question. Various responsible executives were fired. An employee of Bank of America was indicted on criminal securities fraud charges while a hedge fund manager pleaded guilty of criminal violations. The investigation also uncovered "market timing" in mutual fund shares -- a practice usually prohibited in fund prospectuses -- involving rapid-fire trading by hedge funds in shares of international mutual funds across time-zones, for example, a practice that increases mutual fund expenses which have to be borne by all investors, not just the market-timers. In some of the revelations the mutual fund management companies facilitated market-timing trades by revealing to the hedge funds the portfolio weights (allowing them to take short positions) as well as providing direct-access terminals. See "Ex-Broker Charges in Criminal Fraud Case," *New York Times*, 28 September 2003; and "Fund Probe Reaches Prudential," *Wall Street Journal*, October 2, 2003.

[26] In October 2003, for example, J.P. Morgan settled SEC charges with a $25 million fine in one of several laddering allegations against IPO underwriters, supported by e-mail evidence suggesting a *quid pro quo* linking IPO allocations to aftermarket purchases at specific stock price targets. In fact, the case was brought under relatively obscure SEC Regulation M, Rule 101, a technical violation of securities underwriting procedures, as opposed to the more severe Securities Act Rule 10b-5, which covers securities fraud.

[27]For example, in 1995 Den Danske Bank underwrote a secondary equity issue of the Hafnia Insurance Group, stock which was heavily distributed to retail investors, with the proceeds being used to pay-down the bank's loans to Hafnia even as the insurer slid into bankruptcy. The case came before the Danish courts in a successful investor litigation supported by the government -- for a discussion, see Smith and Walter [1997]. Historically, there appears to be little evidence that this potential conflict of interest has in fact been exploited, at least in the United States. During the 1927-29 period investors actually paid higher prices for bonds underwritten by commercial banks subject to this potential conflict of interest than from independent securities firms, and such bonds also had lower default rates. [Puri, 1994] The same finding appeared in the 1990s, when commercial bank affiliates were permitted to underwrite corporate bonds under Section 20 of the Glass-Steagall Act prior to its repeal in 1999. [Gande et al., 1997]. The reason may be that information emanating from the credit relationship allows more accurate pricing, less costly underwriting and reinforced investor confidence. [Puri 1996, Gande et al., 1999].

[28]See Healy & Palepu [2003]. In the case of Enron's Mahonia Ltd. special-purpose entity, J.P. Morgan Chase in 2003 agreed to pay a fine of $25 million to avoid prosecution on criminal charges in a settlement with the New York District Attorney under the 1921 Martin Act. A criminal indictment would have terminated a broad array of fiduciary relationships and triggered large-scale client defections, possibly endangering the continued viability of the bank.

[29]According to the initial report of Enron bankruptcy examiner Neal Batson [2003a], Citigroup alone was involved in over $3.83 billion in Enron financing, including "prepays" and other questionable transactions.

The final report [Batson 2003b] concluded that both Citigroup and JP Morgan (1) "…had actual knowledge of the wrongful conduct of these transactions;" (2) Helped structure, promote, fund and implement transactions designed solely to materially misrepresent Enron's financials; and (3) Caused significant harm to other creditors of Enron.

[30] For a chronology, see Smith and Walter [1997].

[31] Examples: (1) In 1994 the UK Investment Management Regulatory Organisation (IMRO), which regulates pension funds, failed to catch the disappearance of pension assets from Robert Maxwell's Mirror Group Newspapers PLC. The UK Personal Investment Authority (PIA) for years failed to act against deceptive insurance sales practices. (2) In 1996 NASDAQ, one of the key US markets regulated by the National Association of Security Dealers (NASD), and some of its member firms were assessed heavy monetary penalties in connection with rigging OTC equity markets, eventually leading to important changes in regulatory and market practices. (3) In 2001 Moody's (which, along with other rating agencies, is increasingly a part of the regulatory infrastructure) pleaded guilty to criminal charges of obstruction of justice in connection with an SEC investigation of the firm's unsolicited ratings practices. (4) And in 2003 the New York Stock Exchange faced a series of governance issues including the composition of its board, remuneration of its CEO, and alleged conflict of interest exploitation by specialists central to its trading system.

[32] The Act contains extremely broad "fraud" provisions and conveys unusually wide discovery and subpoena power, but had been largely dormant until the 2001-02 revelations of the excesses in market practices and corporate governance failures.

[33] The SEC, supported by lobbyists for financial intermediaries, was quick to promote legislation to strip state securities regulators and prosecutors of the authority to pursue future malfeasance or impose rules on the capital markets, specifically including conflict of interest requirements -- the Securities Fraud Deterrence and Investor Restitution Act of 2003. The SEC clearly felt the need to regain the initiative in regulation of national financial markets, and followed with a series of draft proposals that would simplify conflict of interest rules.

[34] Probably the leading example is the aforementioned $1.4 billion "global settlement" between the regulators and major banks and securities firms involving various allegations of conflicts of interest, as well as smaller amounts of $100 million each that had previously been assessed against Merrill Lynch and CSFB. In turn, financial firms provisioned well over $5 billion to cover hundreds of civil cases filed against them alleging conflicts of interest in financial market practices and aiding and abetting financial fraud.

[35] Banesto's CEO, Mario Condé was later convicted on charges of financial fraud and imprisoned.

[36] More recent examples that are less amenable to event study methodology are precipitous declines during 2002 in Merrill Lynch and Citigroup share prices relative to cohorts immediately following release of new information regarding exploitation of analyst conflicts of interest.

[37] For an empirical study showing an inverse relationship between IPO commissions and excess returns to investors using 1991-2002 UK data, see Ljungqvist [2003].

[38] For example, following the 2003 Global Settlement and its widespread coverage in the media, the proportion of "sell" recommendations rose abruptly, in the US from less than 1% in mid-2000 to about 11% in mid-2003. In Europe the percentage of "sell" recommendations rose from 12% to 24% in Germany, from 13% to 21% in France, and from 6% to 16% in the UK over the same period. See "Your Stock Stinks,

But We Want the Dean," *Wall Street Journal*, July 24, 2003. On the other hand, there was evidence that several of these same firms continued to engage in prohibited sales practices involving analysts outside the United States. See "Wall Street Accord Isn't Global," *Wall Street Journal*, June 6, 2003.

[39] Civil litigation can be an important component of market discipline and its reinforcement of regulatory sanctions. This was evident in the link between the release of the 2003 Global Settlement "findings of fact," the prospects of large civil claims against the financial intermediaries and their corporate clients, and a $1 billion restitution offer negotiated with some 300 companies issuing IPOs in the late 1990s – possibly to be recouped from subsequent civil settlements with the underwriters. Indeed, some of the entrepreneurial characteristics of US tort litigation can be regarded as an important aspect of market discipline relating to conflicts of interest. See "$1 Billion Offered to Settle Suit on IPOs," *The New York Times*, June 27, 2003. However, by no means all civil suits are justified, as seen in a 2003 stinging rebuke to plaintiffs in a class action filed against Merrill Lynch by Judge Milton Pollack. Reuters, 2 July 2003.

[40] A prominent example of weak internal controls in a firm removed from market discipline is the former Prudential Insurance Company of America – since demutualized and renamed Prudential Financial. The firm's securities affiliate, Prudential Securities, was fined $371 million (including $330 million in restitution) in 1993 for mis-selling limited partnerships. In 1996 Prudential was fined $65 million by state regulators for mis-selling life insurance policies, followed in 1997 by a $2.6 billion class action settlement on behalf of 640,000 clients. The firm was fined $20 million in 1999 by NASD for mis-selling variable life insurance, and censured (and fined $10,000) in 2001 by NASD for failing to enforce written policies regarding the sale of annuities. New probes on variable annuity sales practices were launched in 2003 and notified to NASD and state insurance commissioners. It can be argued that persistently misaligned internal incentives would have been a less serious problem if Prudential had been subject to market discipline all along. See Smith and Walter [2000] and "NASD Investigates Prudential, "*Wall Street Journal*, May 30, 2003.

[41]As quoted in *The New York Times*, September 6, 2002.

[42]Such conflicts of interest are particularly problematic in the mutual funds industry due to limited or non-disclosure of fees, incentives and other compensation arrangements, revenue-sharing agreements, trading costs and soft-dollar commissions to brokers.

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Exhibit 1
A Conflict of Interest Taxonomy

Wholesale Domain

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

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

Domain-Transition Issues

Type-1 - Firm-client conflicts.
- Suitability
- Stuffing
- Conflicted research
- Spinning
- Late trading and market timing
- Laddering
- Shifting bankruptcy risk

Retail Domain

Type-1 - Firm-client conflicts
- Biased client advice
- Involuntary cross-selling
- Churning
- Inappropriate margin lending
- Failure to execute
- Misleading disclosure and reporting
- Violation of privacy

Indicative Matrix of Potential Conflicts of Interest

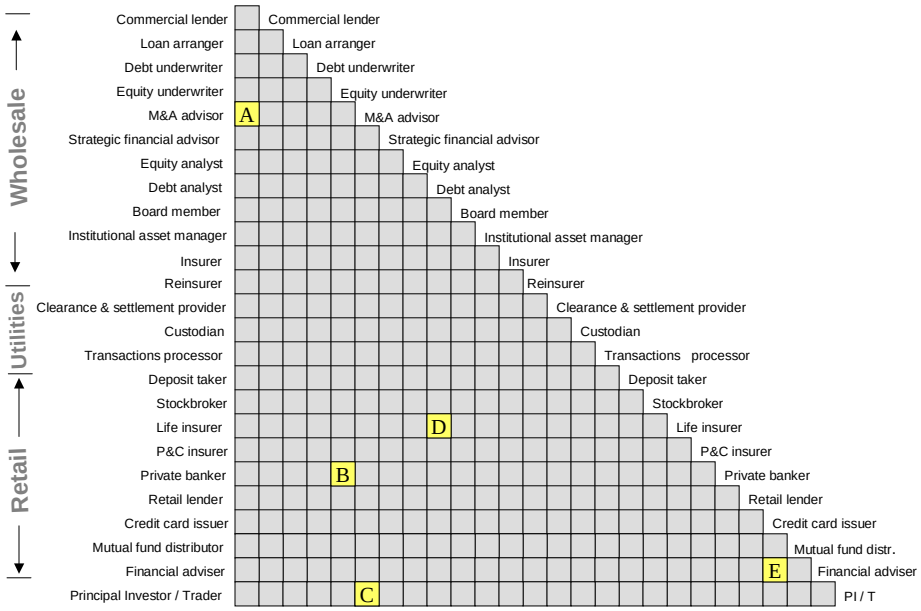
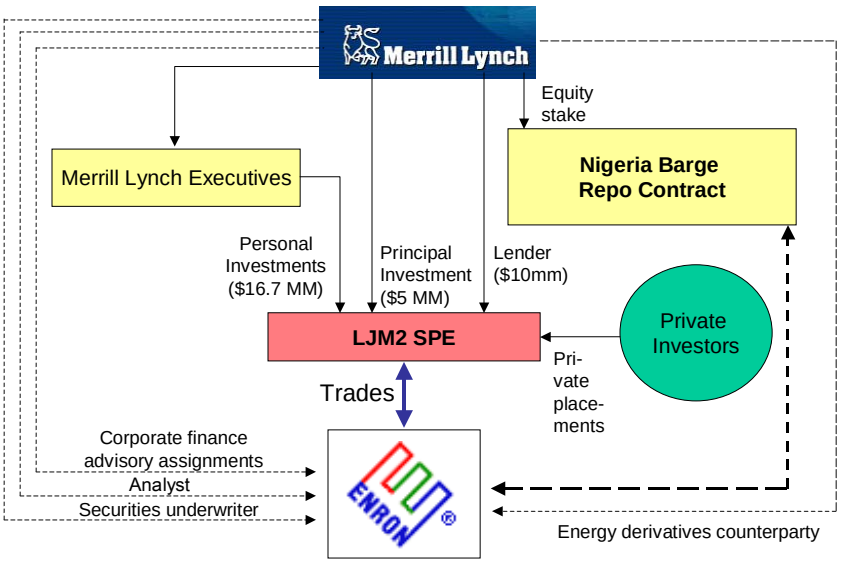


Exhibit 3
Multifunctional Conflicts of Interest: Merrill Lynch - Enron



Fees 1999-2001: Underwriting $20 million; Advisory $18 million; Fund raising ($265 million out of a total of $387 million for LJM2,

Exhibit 4
Multifunctional Conflicts of Interest: Citigroup - Worldcom

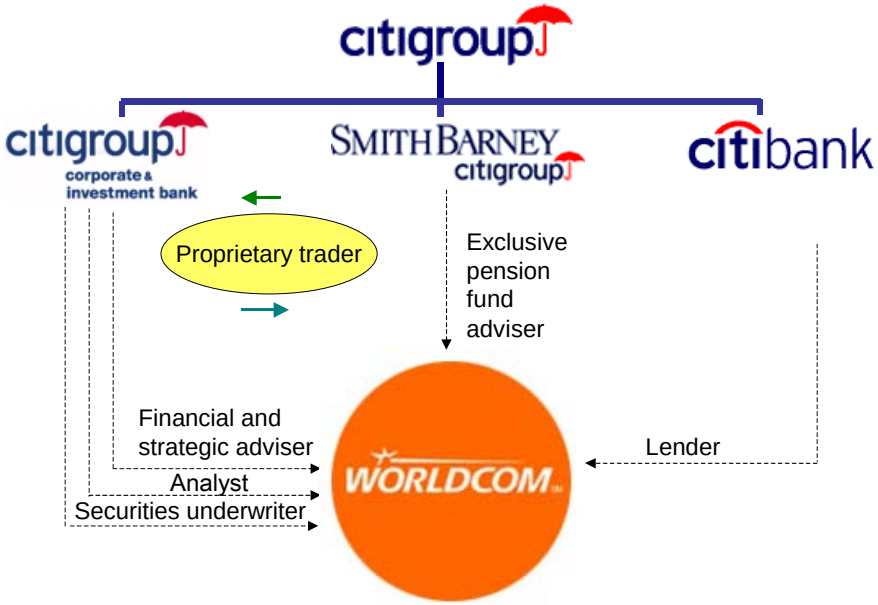


Exhibit 5
Regulatory Tradeoffs, Techniques and Control

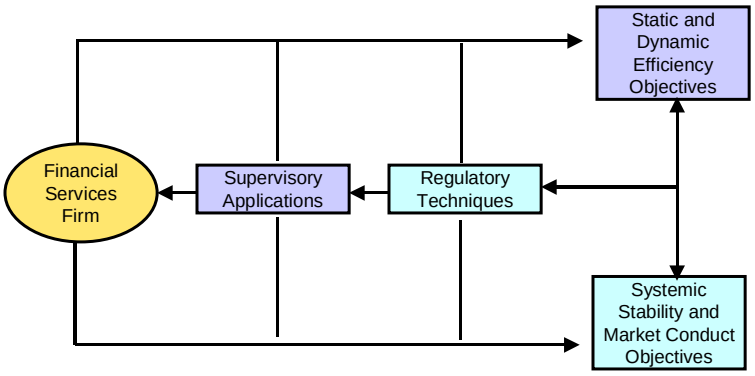


Exhibit 6
Measuring the Stock Price-Effects of Conflicts of Interest