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## Conflicts of interest : disclosure, incentives, and the market

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# **Conflicts of Interest**

## **Corporate Governance and Financial Markets**

*Edited by*

Luc Thévenoz and Rashid Bahar

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## Chapter 1

# Conflicts of Interest: Disclosure, Incentives, and the Market

*Rashid Bahar and Luc Thévenoz\**

Conflicts of interest captured the attention of media and policy makers at the turn of the twenty-first century. Everywhere from corporations to investment banks, conflicts of interest were decried as the source of countless problems. The public called for action and governments and regulators replied with often-draconian laws and regulations, starting with the ominous Sarbanes-Oxley Act of 2002.<sup>1</sup> In this book, we decided to take a step back and analyze the issue more rationally. From the outset, we were aware that it would be pointless to write a monumental treatise on the issue. The law has become far too scattered and specialized to be grasped even-handedly or analyzed adequately from a purely economic perspective. We chose instead to focus on a small sample of specific situations, and examine them from various perspectives in order to reflect the extent and diversity of relationships and markets in which conflicts of interest have become a significant concern.

This book discusses three areas where conflicts of interest were, and remain, a central concern of policy makers world-wide: executive compensation, financial

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1. Sarbanes Oxley Act of 2002, P.L. 107, 204, <[www.sec.gov/about/laws/soa2002.pdf](http://www.sec.gov/about/laws/soa2002.pdf)>.

analysis, asset management and the distribution of financial products.<sup>2</sup> It considers various aspects of conflicts of interest in each of these areas from a legal as well as an economic point of view, combining the insights of scholars, regulators, and practitioners.

This fragmented view of the problem notwithstanding, a number of strong patterns can be discerned through this kaleidoscope.<sup>3</sup> These patterns revolve around the definition of conflicts of interests and the types of relationships that trigger a duty of loyalty. They include the mechanisms available to handle conflicts of interest, from prohibition to disclosure and managerial processes, as well as the extent to which the duty of loyalty may be waived or contracted around. Two further issues emerge in all areas: compensation and enforcement. Compensation is inherent in any commercial transaction; it is simultaneously a source of conflicts of interests and a possible means of reducing these conflicts by creating the proper incentives. Similarly, current law will remain a dead issue unless it is effectively enforced. How the law can be effectively enforced, and by whom, are significant issues discussed in various chapters in this book.

In this introduction we shall review each of these issues in order to highlight the salient themes. We hope that this introduction will serve as a springboard to “plunge” into the rest of the book. We shall attempt a summary definition of conflicts of interest and review the remedies used by the legal system to counter them,<sup>4</sup> with a closer look at compensation and market mechanisms.

## I. WHAT ARE CONFLICTS OF INTEREST?

### A. THE TRADITIONAL APPROACH: FIDUCIARIES AND THE DUTY OF LOYALTY

Interests conflict in any business relationship. Every bargain, even an outright sale, causes at least two different interests to clash with each other,<sup>5</sup> yet they do not fall under the ambit of rules on conflicts of interest. Traditionally, the law only

2. Other areas of interest for research are accountancy firms, rating agencies and universal banking. See A. Crockett, T. Harris, F.S. Mishkin and E.N. White, *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?* (Geneva and London, International Centre for Monetary and Banking Studies and Centre for Economic Policy Research, 2003), pp. 27 *et seq.*, 39 *et seq.* and 55 *et seq.*

3. See also K.J. Hopt, ‘Trusteeship and Conflicts of Interest in the Corporate, Banking, and Agency Law: Toward Common Legal Principles for Intermediaries in the Modern Service-Oriented Society’ in *Reforming Company and Takeover Law in Europe*, G. A. Ferrarini *et al.* (eds) (Oxford, New York, Oxford University Press, 2005), p. 86.

4. See also for a cross-jurisdictional survey, K. Clark *et al.*, *Conflicts of Interest – Jurisdictional Comparisons in the Law and Regulation for the Financial Services, Auditing and Legal Professions 2005/2006* (London, The European Lawyer, 2005).

5. M. Ekemans, ‘Conflits d’intérêts: contrats d’intermédiaires’ in *Les Conflits d’intérêts* (Brussels, Bruylant, 1997), p. 7.

intervenes in situations in which one party owes the other party a specific duty of loyalty; something more than the ordinary duty to act in good faith in business. In such circumstances, the first party must protect and promote the interests of the other party.<sup>6</sup> In other words, the first party is in a delicate situation, being in charge of two conflicting interests. Both common law and civil law jurisdictions have tackled this issue and the outcomes are fundamentally similar. Moreover, there is a clear trend towards convergence of both legal systems.<sup>7</sup> Nevertheless, the differences in sensibility and in remedies are deep rooted and a brief examination of the genealogy of these rules yields precious insights.

In common-law jurisdictions, as Tamar Frankel reminds us in her chapter, this duty is one of the fiduciary duties originating from the law of trusts. The duty of loyalty is a legal consequence of entrusting the trustee with the interests of the beneficiary. Originally the trustee received property. As the scope of the fiduciary relationship expanded, the link between a transfer of property and the duty of loyalty faded away. But this connection remains and explains the deeply property law-like characteristic of the duties of a common law fiduciary.<sup>8</sup>

By contrast, civil-law jurisdictions connect the duty of loyalty to the obligations under a mandate contract,<sup>9</sup> i.e. a contract whereby one party, the agent or mandatee, undertakes to perform a service for or manage the interests of the other party, the principal. The archetypical mandate is a mandate of representation, which empowers the agent to act on behalf of the principal.<sup>10</sup> Such a duty of loyalty may arise from the performance of other services by anyone from a company director to a mere employee. The institution is fundamentally a contractual one, divorced from property-based claims.

Because the execution of the mandate, rather than its result, is at the core of the contract, the duty of care and diligence has traditionally assumed a central position. As Mark Kruithof points out in his chapter, continental jurisdictions do not consider conflicts of interest as such to be a problem. Decision making in a conflicted situation is not a breach of duty. Private law usually calls for at least *prima facie* evidence of damage or undue profits before condemning the conflicted actions.<sup>11</sup>

Despite this historical difference, the gap between these two legal traditions is less significant than it appears, and there are certain convergences between Continental and Anglo-American legal systems. Indeed, it is indisputable that directors

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6. V. Simonart, 'Conclusions générales' in *Les Conflits d'intérêts* (Brussels, Bruylant, 1997), pp. 303–304.

7. For an overview of this issue in corporate governance, see the volume of essays edited by M.J. Roe and J.N. Gordon, *Convergence and Persistence in Corporate Governance* (Cambridge: Cambridge University Press, 2004).

8. See T. Frankel, Chapter 12, p. 364–367, below.

9. Under Swiss law, Art. 394 *et seq.* Code of obligations (CO) RS 220.0.

10. See V. Simonart, 'Conclusions générales', p. 308, identifying the power to act in the interest of someone else as a defining moment on the way to a correct understanding of conflicts of interest.

11. See M. Kruithof, Chapter 10, p. 303–304 and 309–310, esp. no. 139, below.

and officers everywhere owe a duty of loyalty to their companies, and that asset managers owe a similar debt to their clients.

#### B. THE EVER-BROADENING SCOPE OF CONFLICTS OF INTEREST

Conflicts of interest are not limited to individual relationships. If they are widespread, the adverse effects of these conflicts can plague entire markets. If investors believe the agency costs of equity are too high, they will avoid buying shares in favour of bonds, thus limiting the access of business to capital. Similarly, lacking trust in asset managers or collective investment schemes, investors will forego the advantages of this form of investment: the expertise of the agent and the economies of scale offered by asset pooling. Instead, investors will make and implement their investment decisions alone and risk the potentially adverse consequences. From a macroeconomic viewpoint, those consequences can be dire in terms of misallocation of resources: capital markets may dry up and savings may vanish or be inefficiently invested. Conflicts of interest thus are a source of concern not only for individual principals, but also for society at large, and indeed the state.<sup>12</sup> Public regulation is necessary insofar as individuals may not be able to fend for themselves and cannot enforce their rights alone.

The regulation of financial markets has, however, introduced a new paradigm; a new approach with new tools. In addition to contract or fiduciary law claims, regulators took this issue into their own hands, using the instruments of administrative law. This new approach is obvious with regard to asset management and investment funds. EU rules such as the UCITS Directive,<sup>13</sup> the Investment Services Directive of 1993,<sup>14</sup> and its successor, the Directive on Markets in Financial Instruments,<sup>15</sup> all provide for an administrative duty of loyalty, or at least on conflicts of interest, which is supplementary to the requirements of private law.<sup>16</sup> Swiss law has followed

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12. A. Crockett, T. Harris, F. S. Mishkin and E.N. White, *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?*, pp. 76–77. For to the duty of loyalty of worker representatives on German co-determined boards see K.J. Hopt, 'Trusteeship and Conflicts of Interest in the Corporate, Banking, and Agency Law: Toward Common Legal Principles for Intermediaries in the Modern Service-Oriented Society', p. 76.
  13. Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (85/611/EEC) OJ L 375/3, 1985 (hereafter 'UCITS Directive'). This directive has been modified by several subsequent directives. A current, consolidated text is available at <[www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:01985L0611-20050413:EN:NOT](http://www.eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:01985L0611-20050413:EN:NOT)>.
  14. Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ L 141/27, 1993 (hereafter 'ISD').
  15. Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments, amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145/1, 2004 (hereafter 'MiFID').
  16. Art. 18 MiFID; art. 10 (2) and 17 UCITS Directive; art. 10 and 11 ISD.

the same trend with the Investment Funds Act<sup>17</sup> and the Stock Exchange Act:<sup>18</sup> both impose a duty to act in the client's best interests and an implied rule on conflicts of interest that is expanded by regulatory and self-regulatory instruments.<sup>19</sup>

The increasing role of regulators is also obvious in the realm of corporations. Until recently, the border between corporate and securities law was clear-cut: the latter tackled only issues of disclosure, leaving the internal affairs of the company, and the entire governance system, to corporate law.<sup>20</sup> The emergence of corporate governance codes, and their integration in various listing rules, has eroded this difference. These codes opened the way for securities regulators to intervene at the core of corporate governance and gave it a new dimension. In particular, as one of us points out in his chapter, whereas traditional corporate law was not strongly concerned with issues of executive compensation,<sup>21</sup> securities law, broadly speaking, required the disclosure of compensation packages and called for increased scrutiny over the governance practices of boards and remuneration committees in particular.<sup>22</sup>

The regulatory action improved enforcement and, optimally, compliance with these rules. Regulators are not subject to the usual problems that plague the dispersed mass of small investors. They have better tools to tackle the issue directly. Moreover, regulators can take enforcement action even if no damage has been suffered or can be proved. Non-compliance alone can trigger measures by authorities.<sup>23</sup>

In addition to stronger enforcement, the regulatory approach to conflicts of interest also led to an expansion of the scope of fiduciary duties. Formerly, regulation was primarily concerned with the prudential supervision of institutions, including

17. Loi fédérale du 18 mars 1994 sur les fonds de placement (Loi sur les fonds de placement, LFP) RS 951.31, abbreviated in English as 'IFA' Trend confirmed by the loi fédérale du 23 juin 2006 sur les placements collectifs de capitaux (loi sur les placements collectifs, LPCC), FF 2006 5533, which is set to enter in force in 2007.

18. Loi fédérale du 24 mars 1995 sur les bourses et le commerce des valeurs mobilières (Loi sur les bourses, LBVM) RS 954, abbreviated in English as 'SESTA'.

19. See art. 11 (1)(a) SESTA; art. 12 and 20 IFA.

20. See *Santa Fe Industries Inc. v. Green* 430 U.S. 462, 478–480 (1977).

21. Until the recent revision of the Swiss Code of Obligations, Swiss law included only one provision on compensation. The provision governed *tantièmes*, an instrument that is rarely used in practice. However, general principles of corporate law and, in particular, the general duty of diligence and loyalty ensured that the issue did come within the ambit of the law. See [R. Bahar Chapter 3, p. 91–92, below and refs. Since 7 October 2005, Parliament has enacted a new provision on the disclosure of executive compensation: Code des obligations (CO) (Transparence des indemnités versées aux membres du conseil d'administration et de la direction), Modification du 7 octobre 2005, FF 2005 5593. Subsequently the government moved forward and published a consultation paper on the revision of corporate law that would allow companies to put remuneration packages to the ballot. Art. 627 (4) draft CO. *Begleitbericht zum Vorentwurf zur Revision des Aktien- und Rechnungslegungsrechts im Obligationenrecht vom 2. Dezember 2005*, <www.bj.admin.ch>, p. 40. See R. Bahar, Chapter 3, p. 92, below.

22. See, e.g., the SWX Corporate Governance Directive.

23. See generally S. Shavell, 'The Optimal Structure of Law Enforcement' (1993) *Journal of Law and Economics* 36, 255, 263–271 on various forms of enforcement and their advantages.



the adequacy of their organization and their capital base. More recently, regulators have been more inclined to probe the very content of the agreement between intermediaries and their customers by enforcing rules of conduct and trying to prevent market abuse, thus delving into the particulars of the relationship.<sup>24</sup>

This heightened scrutiny went hand in hand with an expansion of the circle of beneficiaries of the duty of loyalty. Regulators often take the view that financial intermediaries owe loyalty to the investing public at large. The first wave of investor-protection regulation was limited to a series of reinforced pre-contractual duties, requiring issuers to disclose all material and relevant facts and barring them from defrauding investors.<sup>25</sup> This regulation has changed recently: allotment rules for new issues,<sup>26</sup> and more specifically rules of conduct for analysts,<sup>27</sup> require financial intermediaries to take action to prevent conflicts of interests from tainting their interactions with the public at large. In both cases, the regulator considered that the duty of loyalty of securities dealers requires them to treat all clients fairly when a conflict arises between those clients' individual interests.<sup>28</sup>

The case of analysts is exemplary in this respect. As Sandro Abegglen points out in his chapter, sell-side analysts, who are hired and paid by underwriters and M&A advisors, do not enter into a direct contractual relationship with investors. Unlike buy-side analysts, who are paid to advise clients on how to invest their assets, there is no doubt where the interests of sell-side analysts lie: with their securities house and possibly with the firm whose securities the securities house underwrites, and not with the investor.<sup>29</sup> Empirical studies reviewed by Michel Dubois and Pascal Dumontier show that the market is not deceived, and discounts the enthusiastic language of sell-side analysts.<sup>30</sup> Although the Global Research Analyst Settlement of 2003<sup>31</sup> and various regulatory and self-regulatory initiatives<sup>32</sup> have enabled greater integrity in the marketplace, the overall efficiency of the new arrangements has yet to be tested. Has the problem been solved or merely shifted? The UK

24. Although this trend is new in banking and investment services, insurance regulators have traditionally exercised this scrutiny. See Art. 46 (1)(f) of the Loi fédérale sur la surveillance des entreprises d'assurance (Loi sur la surveillance des assurances, LSA) RS 961.01.

25. The U.S. Rule 10b-5 is most likely emblematic of this trend.

26. See the Directive of the Swiss Bankers Association on the Issuance Market, <[www.ebk.ch/f/regular/rundsch/pdf/04-02\\_Anhang/Zirkular7332.pdf](http://www.ebk.ch/f/regular/rundsch/pdf/04-02_Anhang/Zirkular7332.pdf)> (in French).

27. Swiss Bankers Association's Directives on the Independence of Financial Research <[www.swissbanking.org/en/3566\\_e.pdf](http://www.swissbanking.org/en/3566_e.pdf)>.

28. See e.g. Decision of the Federal Banking Commission of 19 March 2003, in regard to the *Bank Vontobel*, Bulletin CFB 45 (2003) 165. Art. 11 SESTA.

29. Art. 8 of the Swiss Bankers Association Code of Conduct for Securities Dealers, <[www.swissbanking.org/en/8019\\_e.pdf](http://www.swissbanking.org/en/8019_e.pdf)>. See S. Abegglen, Chapter 5, p. 171, below.

30. M. Dubois and P. Dumontier, Chapter 6, p. 187 et seq., below.

31. Global Research Analyst Settlement of 2003, <[www.sec.gov/spotlight/globalsettlement.htm](http://www.sec.gov/spotlight/globalsettlement.htm)>.

32. See in Switzerland, the Swiss Bankers Association's Directives on the Independence of Financial Research, <[www.swissbanking.org/en/3566\\_e.pdf](http://www.swissbanking.org/en/3566_e.pdf)>. The Federal Banking Commission required all supervised banks and securities dealers to comply with the terms of this instrument as a self-regulation norm recognized as a minimum standard. See the Circulaire CFB 04/2 du 21 avril 2004, Normes d'autorégulation reconnues comme standards minimaux par la CFB.

Financial Services Authority recently expressed a suspicion that issuers are trying to pressure investment banks into breaching the rules governing the independence of financial analysts by delaying the selection of the lead underwriter.<sup>33</sup>

### C. EROSION AND WAIVERS OF THE DUTY OF LOYALTY

This expansion of the duty of loyalty beyond its original scope is creating stress in business relationships. Whereas in the words of Cardozo, for a trustee not ‘honesty alone, but the punctilio of honour the most sensitive, is . . . the standard of behaviour’,<sup>34</sup> this rule was relaxed early in the development of corporate law by the business judgment rule.<sup>35</sup> And few would argue that an investment banker is bound by the same rules as a trustee. This gradual erosion was not the product of contractual innovations or conscious judicial decisions, but rather was simply the evolution of the marketplace.

Loyalty comes at a cost. For the agent, this fact is obvious. Paraphrasing Cardozo’s famous dictum once again, agents cannot simply act in accordance with common market practice; they must take additional steps to meet the high standards of behaviour expected of them.<sup>36</sup> Principals, however, also have to bear the costs of loyalty: conflicts of interests may prevent them from hiring the most experienced and specialized agents to defend their interests.<sup>37</sup> The principals may have to settle for a lower standard of quality in exchange for higher integrity, and the trade-off is not easy to quantify.

33. See FSA, ‘Competitive Initial Public Offerings’ List! No. 11, Supplementary Edition November 2005, 1 <[www.fsa.gov.uk/pubs/ukla/list11\\_suped.pdf](http://www.fsa.gov.uk/pubs/ukla/list11_suped.pdf)>.

34. *Meinhard v. Salomon*, 164 N.E. 545 (N.Y.1928) at 546.

35. See on this topic, §4.01(c) American Law Institute Principles of Corporate Governance; *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) 812; *Smith v. Van Gorkom*, 488 A. 2d 858 (Del. 1985). See also under Swiss law, e.g. SJ 1982 221, c. 3a, 225; ATF 113 II 52, c. 3a, 57; R. Bahar, *Le rôle du conseil d'administration lors des fusions et acquisitions: une approche systématique* (Zurich, Schulthess, 2004) pp. 90–98; L. Glanzmann, ‘Die Verantwortlichkeitsklage unter Corporate Governance-Aspekten’, *Revue de droit suisse* 119 (2000) II 135, 165–166; A.R. Grass, ‘Management-Entscheidungen vor dem Richter: Schranken der richterlichen Überprüfbarkeit von Geschäftsentscheidungen in aktienrechtlichen Verantwortlichkeitsprozessen’, *Revue suisse de droit des affaires* 72 (2000) 1–10; A.R. Grass, *Business Judgment Rule: Schranken der richterlichen Überprüfbarkeit von Management-Entscheidungen in aktienrechtlichen Verantwortlichkeitsprozessen* (Zurich, Schulthess, 1998); Trigo Trindade and Bahar, ‘Droits des actionnaires minoritaires en Suisse’, p. 396; H.C. von der Crone, ‘Auf den Weg zu einem Recht der Publikumsgesellschaften’, *Revue de la société des juristes bernois* 133 (1997) 73, 107; P. Widmer and O. Banz, in *Basler Kommentar zum Schweizerisches Privatrecht*, N.P. Vogt, R. Watter, and H. Honsell (eds) (Basle, Geneva, Munich, Helbing & Ichtenhahn, 2002) ad art. 754 CO, no. 31.

36. *Meinhard v. Salomon*, 164 N.E. 545 (N.Y.1928) at 546.

37. This point is made cogently by M.C. Jensen and W.H. Meckling, ‘Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure’ *Journal of Financial Economics* 3 (1976) 328.

Considering how difficult it is to measure loyalty, the law usually enshrines loyalty as a mandatory duty. This policy does not seek merely to protect the weaker party. A principal, however sophisticated and commercially alert, cannot waive her fiduciary's duty of loyalty. As Tamar Frankel points out, this problem stems from common-law jurisdictions with the proprietary nature of the duty. At most, a principal may consent to a conflict of interest once she is aware of it, and can presumably measure the adverse consequences of the conflict.<sup>38</sup>

Although this principle may appear far reaching, and might be expected to prove a considerable handicap to the financial industry, ways around the roadblock are built by the absolute nature of the duty of loyalty. First, the parties can narrow the scope of the service or the interests entrusted. Execution-only brokers, for instance, promise nothing more than a diligent, careful and loyal execution of exchange orders. These brokers do not provide any form of financial advice to their customers. They do not even promise to ensure that the trades match the risk profile of their clients. Perhaps the future lies with an explicit definition of the services an intermediary promises to provide: execution-only; trade-related advice; general assessment of the financial situation of the client; and investment management.

Nevertheless, views to the contrary notwithstanding, we do not believe that this evolution is redefining the duty of loyalty. It remains a discrete variable: a fiduciary is either loyal or she is not; she cannot be more or less loyal. She can only contract in the domain of her loyalty. Once she enters into this area, she is bound to an unlimited loyalty to her principal. The face of this duty may change, depending on the circumstances and the nature of the relationship. But the duty itself remains fundamentally the same: the agent must act in the interest of the principal.

## II. COMPENSATION

### A. COMPENSATION AS A SOURCE OF CONFLICTS OF INTEREST

Compensation schemes are arguably one of the main sources of conflicts of interest. This fact is somewhat surprising, because the compensation an agent or fiduciary receives is part of the bargain between the fiduciary and the principal and falls outside the scope of the former's duty of loyalty. In addition, the fiduciary and the principal both agreed to the compensation scheme, at least implicitly. Thus, even if a given type of remuneration creates perverse incentives, it will not automatically fall under conflict of interest rules. However, in many instances, it does. The remuneration can fall under conflict of interest rules, for example, if an agent fails to carry out his duties to the best interest of his principal, due to misguided incentives. In such cases, the incentive scheme does not, as such, constitute a breach of the

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38. See T. Frankel, Chapter 12, p. 365 et seq., below.

duty of loyalty, but instead encourages the fiduciary to take action that contravenes his duty of loyalty.

From asset managers to financial analysts, payment schemes have created perverse incentives. Corporate history is rife with stories of bonus schemes that have run amok, encouraging pushing managers to dump products on clients in order to meet quarterly sales targets, at the expense of the firm's long-term interest in maintaining proper relations with customers.<sup>39</sup> Stock option plans can also engender an entire series of conflicts of interest and perverse incentives, ranging from short-term bias to excessive payouts at the expense of shareholders as the result of a failure to understand the value of the options granted under the plan.<sup>40</sup>

Not only existing shareholders stand to lose from perverse effects of stock option plans: managers themselves may feel tempted to 'cook the books' and engage in other fraudulent activities to boost their profits. Managers may also use milder schemes and engineer false expectations to create an appearance of over-performance.<sup>41</sup> As a result, the entire market may lose confidence in the accuracy of financial reports. Guido Bolliger and Manuel Kast confirm empirical findings that corporate managers with high incentive schemes influence the stock price by analyst guidance and other forms of expectation management.<sup>42</sup> Using informal channels they persuade the market to reduce earnings forecasts, which will be beaten by the results subsequently reported. As Guido Bolliger and Manuel Kast show, equity-based plans, management shareholdings, and bonus plans foster this behaviour. Financial analysts are willing victims in this scheme. They depend on good relations with management in order to access information. It is therefore quite logical for them to issue biased forecasts so as to secure future information from management.<sup>43</sup>

This conflict is not the only one to which analysts are exposed. More generally, sell-side analysts working for investment banks who act as underwriters for the companies they cover have implicit incentives to issue favourable reports. They do not directly generate revenues: institutions offer their reports for free, hoping that they will yield new investment banking or trading business. Sell-side analysts thus have a limited interest in objective and independent research if it comes at the expense of trading or underwriting business.<sup>44</sup>

This conflict of interest is more or less explicit, ranging from a direct link between analyst compensation and the performance of the investment banking division or the trading desk, to more subtle and less controllable career considerations. Nevertheless, as Michel Dubois and Pascal Dumontier show, only the

39. See, for numerous examples, M.C. Jensen, 'Paying People to Lie: The Truth about the Budgeting Process' (2003) *European Financial Management* 9, 379.

40. See L.A. Bebchuk and C.M. Fried, *Pay without Performance*, pp. 137–185.

41. See R. Bahar, Chapter 3, p. 113–116, below.

42. See G. Bolliger and M. Kast, Chapter 4, p. 137 et seq., table 2, below.

43. See R. Bahar, Chapter 3.

44. See FSA, 'Competitive Initial Public Offerings' List! No. 11, Supplementary Edition November 2005, 1 <[www.fsa.gov.uk/pubs/ukla/list11\\_supd.pdf](http://www.fsa.gov.uk/pubs/ukla/list11_supd.pdf)>.

investment recommendations, and not the earnings forecasts, reveal actual bias. More significantly, these authors also point out that the market is not gullible and is quite capable of taking such bias into account.<sup>45</sup> This leaves us wondering whether the regulatory tsunami of the last five years, which is vividly described by Sandro Abegglen<sup>46</sup> and Jean-Baptiste Zufferey,<sup>47</sup> will actually yield any benefit in this area. This attempt to restore public confidence may have succeeded in terms of media spin, but at what cost remains to be seen.

Although the regulatory pressure was less felt in this area, asset managers are also exposed to conflicts of interest because of the structure of their compensation. ‘Churning portfolios’ – generating excessive trading to increase revenue – is a well-known risk that most investors are aware of and can monitor. They may be less aware of other quirks. Independent asset managers typically enjoy some form of revenue sharing with the brokers who execute their orders on behalf of investors. In this book, we make frequent use of the word ‘retrocessions’ to designate commissions paid by banks and securities brokers to asset managers out of their own fees. Typically, institutional investors bargain with their asset managers for a net fee, and the asset managers guarantee that their clients will benefit from any connected income received from third parties. This is often explicitly regulated with regard to companies that manage investment funds. The same problem nonetheless exists with regard to individual investors, who lack the commercial power to achieve the same bargain. It has not yet drawn the attention of Swiss or EU regulators, except for the UK Financial Services Authority’s ‘new menu’ approach for independent financial advisors.<sup>48</sup>

However, this may be changing. In the related area of distribution of investment funds to retail investors, the Swiss Fund Association, with the backing of the Swiss Federal Banking Commission, has called for the disclosure of various types of commissions that fund managers pay to distributors and other intermediaries. Yet, as one of us (Luc Thévenoz) points out in his paper, the problem extends beyond the question of conflicts of interest to encompass competition law and perhaps the controversial issue of corruptive practices.<sup>49</sup> Indeed, the competition for shelf-space in the fund industry and the fostering of open architecture raise fundamental questions for the industrial organization of the financial sector. Moreover, whereas a retrocession can be viewed as the purchase of precious shelf-space, a relatively innocuous transaction similar to what goes on every day in supermarkets, we could also see it as a form of corruption. Whenever a fund manager offers retrocessions, she is implicitly inducing the distributors to disregard the interest of their clients. In this respect, her behaviour does not differ fundamentally from that of a firm that pays a public servant a kickback for contracting with it.

45. M. Dubois and P. Dumontier, Chapter 6.

46. S. Abegglen, Chapter 5, p. 171 et seq., below.

47. J.-B. Zufferey, Chapter 7, p. 211 et seq., below.

48. Financial Services Authority, *Reforming Depolarisation: Implementation*, Policy Statement 04/27, November 2004, available at [www.fsa.gov.uk](http://www.fsa.gov.uk), discussed by L. Thévenoz, Chapter 11, p. 351, below.

49. L. Thévenoz, Chapter 11, p. 337, below.

## B. COMPENSATION AS A SOLUTION TO CONFLICTS OF INTEREST

In the realm of conflicts of interest, compensation assumes the appearance of the two-faced Roman god Janus: On one side, compensation is a source of conflicts, while on the other, it is a remedy. This ambivalence is obvious with respect to executive compensation. Corporate governance commentators, particularly Jensen and Murphy, called for incentive plans as a solution to the agency conflict between shareholders and managers, and advocated the use of numerous performance-based schemes, ranging from bonuses to stock-option plans.<sup>50</sup> In hindsight, however, many of these proposals seem to have failed to attain their objective. Rather than aligning the interests of managers with those of shareholders, they created perverse incentives, in the worst case inducing executives to commit fraud and other crimes.

Does this mean that incentive plans are useless and that managers should again be paid like bureaucrats? Probably not. The floodgate is open and the challenge now is to design an appropriate compensation package. Which is precisely what Rolf Watter and Karim Maizar set out to do in their chapter. From a corporate governance perspective, they explain the legal principles that must be respected by boards of directors and compensation committees. They also describe the constraints imposed by the legal system on the structure itself.<sup>51</sup> Performance-based fees, however, are used beyond the corporate arena. It is not uncommon for these fees to be paid to asset managers and fund managers.<sup>52</sup> Looking beyond the scope of the financial industry, U.S. law and economics commentators have praised attorneys' contingency fees as mechanisms helping plaintiffs, who are often unsophisticated and do not know the law, to ensure that their lawyers only advise them to litigate if they have a good chance of success.<sup>53</sup>

## C. INTRINSIC MOTIVATION AND NON-MONETARY INCENTIVES

Half-way between the ideal answer to conflicts of interest and their very source, compensation schemes are obvious targets for regulation. Although there have been no widespread attempts in the financial industry to regulate the amount of compensation payable to a financial intermediary or corporate officer, certain forms of compensation have been banned. For instance, lawyers in many continental European jurisdictions are barred from receiving contingency fees;<sup>54</sup> they are, however,

50. See the twin papers published in 1990 by M.C. Jensen and K.J. Murphy, 'CEO Incentives – It's Not How Much You Pay, But How' (1990) *Harvard Business Review* 68, 138, and 'Performance Pay and Top-Management Incentives' (1990) *Journal of Political Economy* 98, 225–264.

51. R. Watter and K. Maizar, Chapter 2, p. 31 et seq., esp. at 49 et seq., below.

52. See in the US, U.S. General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure*, GAO-03-551T (Washington, D.C.: 12 March 2003), finding an increase in management fees due to the use of performance-based fee schedules.

53. R. Cooter and T. Ulen, *Law and Economics* (3rd edn, Reading, MA, et al, Addison-Wesley, 2000), p. 390.

54. See Art. 3.3 of the Code of Conduct for lawyers in the European Union, <[www.ccbe.org/doc/En/code2002\\_en.pdf](http://www.ccbe.org/doc/En/code2002_en.pdf)>.

often allowed to receive a success fee in addition to their non-performance-based pay.<sup>55</sup> The policy reason is that contingent remuneration jeopardizes the independence and integrity of lawyers. From this perspective the lawyer is part of the judicial system, and if he were too committed to the interests of his clients, he might be induced into forgetting his duties as an officer of the court. Does this suggest that the legal system expressly seeks to decouple the interests of the agent from those of the principal? Or is it an implicit and early recognition that remuneration too strongly dependent on the success of the agent creates overreaching effects detrimental to the interests of the principal?

Regulators also followed this approach with respect to financial analysts: under the rules adopted by the Swiss Bankers' Association, sell-side analysts are barred from investing in firms they cover.<sup>56</sup> This is obviously quite paradoxical from an incentive theory perspective. It implies that analysts will be more conscientious if they are disinterested than when their vested interests are involved. This policy is even more disturbing because buy-side analysts who also act as asset managers are obviously free to apply their own recommendations to the portfolio they manage.

In the corporate arena, several commentators have been critical of the practice of offering stock options to directors on the grounds that they could lose their independence. Peter Böckli, for example, in his treatise on Swiss corporate law, strongly advises against giving directors any form of stock-option-based compensation. He suggests only that directors should be invested in the companies they serve.<sup>57</sup>

However, a fundamental assumption underlies these policies: that financial incentives have a corrupting effect. Either they attract the wrong type of people to the job or they crowd out other values such as integrity and intrinsic motivation.<sup>58</sup> This second danger is a major source of concern, because it undermines reputation-based incentive schemes, which may be more effective in disciplining fiduciaries.<sup>59</sup> Indeed, unless an individual agent is at the very end of his career, he will inevitably seek to preserve his reputation to secure promotion within the firm or on the general labour market. Similarly, firms may want to preserve their reputation for integrity in order to secure future business.

### III. REMEDIES: DISCLOSURE AND ORGANIZATIONAL MEASURES

#### A. CAN THE MARKET SOLVE THE PROBLEM?

Early on, Eugene Fama suggested that the market would constrain agents and thus solve the agency problem. In a competitive market, any agent who does not pull her

55. See in particular Art. 19(3) of the Code de Déontologie of the Swiss Lawyers' Association, <[www.bgfa.ch/fr/01\\_gesetze/03\\_standesregeln.htm?eintrag\\_id=549](http://www.bgfa.ch/fr/01_gesetze/03_standesregeln.htm?eintrag_id=549)>.

56. Para. 33 Swiss Bankers Association Directives on the Independence of Financial Research, <[www.swissbanking.org/en/3566\\_e.pdf](http://www.swissbanking.org/en/3566_e.pdf)>.

57. See P. Böckli, *Schweizer Aktienrecht* (3rd edn, Zurich, Schulthess, 2004) 13, no. 244–246.

58. See R. Bahar, Chapter 3, p. 88, below.

59. See *ibid.*

weight will be outdone by more loyal agents who promise better performance at a lower cost. In the corporate environment, individuals are disciplined by the market for managers and directors. Firms are active in product and capital markets and, if they are unable to control their agency costs, their competitors will offer better products at cheaper prices and will be able to finance themselves at a lower cost. Ultimately, the market for corporate control may save the investors: a competing management team may take over control and will then curtail agency costs. If in spite of these constraints the management does not improve, failure and bankruptcy are inevitable and the firm will be eliminated from the market economy. However, all these constraints are relatively loose and will operate only if the disloyalty is egregious.<sup>60</sup>

This argument also works for other conflicts of interest. Underwriters, for example, are at the heart of a conflict of interest between the firms whose securities they underwrite and the investors to whom they seek to offer them; and yet this does not seem to create excessive problems. Reputation and competition in this market sector seem to keep a check on disloyalty.<sup>61</sup> And this is not solely an effect of primary market regulation; as George Stigler and later Carol Simon pointed out, the market already encouraged substantial disclosure before the enactment of the Securities Act of 1933. The new regulation did not affect the mean returns of securities traded on the NYSE, or even of seasoned issues of securities traded on smaller exchanges.<sup>62</sup> At the time the 'money trust' of J. P. Morgan and other financiers ruled Wall Street, disclosure was already substantially developed. As this example hints, market participants often intentionally look for conflicted partners, hoping that their fiduciary is 'in the know.'

The market could also work with respect to the distribution of financial products or asset management. If a fund distributor allows retrocessions to influence her decisions, her competitors will outrace her by offering investors better products. If an asset manager churns the portfolio of her clients, thus increasing the overall costs of her services, in a competitive market, her customers may decide to change to a cheaper service provider.

There is a catch, however. If the markets are not competitive, they will not be a sufficient constraint to discipline the agent, in which case rules may prove necessary. Moreover, most agency services suffer from a fundamental problem: the quality of the service is not directly observable<sup>63</sup> and a third party can only infer them from the outcome and other proxies. The agent can invest to build a reputation. She can hire an auditor to certify that she is complying with applicable

60. E.F. Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economy* 207. See also A. Crockett, T. Harris, F.S. Mishkin and E.N. White, *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?* p. 7.

61. Ibid. pp. 15 and 73.

62. C.J. Simon, 'The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues' (1989) *The American Economic Review*, 79 S2:295–318; G.J. Stigler, 'Public Regulation of the Securities Markets' (1967) *Journal of Business* 37, 117–142.

63. A. Crockett, T. Harris, F.S. Mishkin and E.N. White, *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?* p. 7.



rules. An agent can join a professional association and commit herself to a ‘code of conduct’ or other ‘ethical principles.’<sup>64</sup> Investment banks followed a similar strategy after the analyst scandals that followed the bursting of the Internet bubble; and they responded by voluntarily reforming their internal organization<sup>65</sup> and promoted directives and codes of conduct.<sup>66</sup> Often, these actions will suffice to overcome the information asymmetry. However, in other cases it may be more difficult to separate ‘good’ types from ‘bad’ types; worse still, opportunistic individuals will be able to capture a firm’s reputational rents, eventually destroying the firm’s accumulated goodwill and possibly damaging the credibility of the entire industry.<sup>67</sup> Regulation and supervision may prove necessary to solve this ‘lemons’ problem<sup>68</sup> and, ultimately, to ensure an efficient outcome.<sup>69</sup>

Competition policy can thus be an answer to conflicts of interest.<sup>70</sup> Alternatively, as Davis points out, conflict of interest rules can be read as a part of broader set of rules intended to solve the problem of lack of competition in certain markets.<sup>71</sup> For instance, if disclosure is required, and in particular if its accuracy is implicitly certified through enforcement, this may help make the market more transparent and hence more competitive.

However, regulation comes at a cost: if rules on conflicts are excessively tough, they prevent specialized actors from sharing their knowledge. This can present a problem when the benefits of specialization exceed the agency costs. Put bluntly, a qualified but conflicted agent is often preferable to an honest but incompetent one.<sup>72</sup> Rules can also be anti-competitive and lead to the fragmentation of markets. To a certain extent, this is the case in the financial industry, where regulatory pressure encourages greater protection of the retail investor, thus reinforcing the segmentation of the market between institutional and retail investors.

## B. PROHIBITION

Traditionally, most legal systems called for the fiduciary to abstain from acting in a conflicted situation. This rule is still operative and applies regularly to certain

64. See e.g. this proposal in connection with rating agencies, *ibid.* p. 52.

65. *Ibid.* p. 24.

66. See e.g. the Swiss Bankers Association’s Directives on the Independence of Financial Research <[www.swissbanking.org/en/3566\\_e.pdf](http://www.swissbanking.org/en/3566_e.pdf)>.

67. A. Crockett, T. Harris, F.S. Mishkin and E.N. White, *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?* p. 77.

68. See G. Akerlof, ‘The Market for “Lemons”: Quality Uncertainty and the Market Mechanism’ (1970) *Quarterly Journal of Economics* 84, 488–500.

69. A. Crockett, T. Harris, F.S. Mishkin and E.N. White, *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?*, p. 74.

70. See *ibid.* p. 81, suggesting this solution for the rating agency industry, but excluding it for analysts, auditors and most financial institutions.

71. K.B. Davis, Jr., ‘Judicial Review of Fiduciary Decisionmaking – Some Theoretical Perspectives’ (1985) *Northwestern University Law Review* 80, 1, 6.

72. M.C. Jensen and W.H. Meckling, ‘Theory of the firm: Managerial behaviour, agency costs and ownership structure’, p. 328.

intermediaries. Lawyers in particular are traditionally barred from representing two clients with conflicting interests. In the financial and corporate world, some global firms learned the hard way that this rule is still alive and kicking.<sup>73</sup> Although bound by a duty of independence rather than a duty of loyalty, auditors are increasingly called upon to turn down any business that may compromise their integrity.<sup>74</sup>

However, due to its rigidity,<sup>75</sup> this approach is waning in the financial industry: From asset managers to financial analysts, none of the commentators recommends such a radical approach, at least as a mandatory rule. In the United States, the Gramm-Leach-Bliley Act of 1999<sup>76</sup> undid the Glass-Steagall Act of 1933,<sup>77</sup> indicating that even the archetypical conflict between investment banking and commercial banking is no longer a source of concern for lawmakers.<sup>78</sup> In Europe, as Marc Kruithof rightly notes, neither the UCITS Directive nor the Directive on Markets in Financial Instruments requires financial institutions to take measures to avoid conflicts of interest. Instead, financial institutions are merely required to mitigate these conflicts and treat their clients fairly.<sup>79</sup>

Nevertheless, one of us (Luc Thévenoz) suggests in his paper that a rule calling for a prohibition of conflicts of interests could be used as a default rule which parties could contract out of subject to mutual consent based on appropriate disclosure. Even in these circumstances, however, the prohibition is not absolute, nor is the rule seriously intended to apply. Rather, it serves as a backdrop against which the parties can negotiate and achieve an efficient outcome.<sup>80</sup>

At the same time, the costs of managing conflicts of interest, and the reputation risks they create, seem to prompt some financial firms to spontaneously disaggregate into smaller, more specialized and less conflicted business units. Marc Kruithof and Eddy Wymeersch both note that some financial conglomerates have spun off their

73. *Marks & Spencer PLC v Freshfields Bruckhaus Deringer* [2004] EWHC 1337 (Ch), upheld Court of Appeal [2004] EWCA Civ 741; *Prince Jefri Bolkiah v KPMG* [1999] 1 All E.R. 517 [House of Lords].

74. See e.g. Commission Recommendation of 16 May 2002 – Statutory Auditors' Independence in the EU: A Set of Fundamental Principles (Text with EEA relevance) (notified under document number C(2002) 1873), OJ L 191/22, 2002. In Switzerland, see Art. 727c CO and in the banking area, Circ. CFB 05/03 Sociétés d'audit, items 15ff. In the US, see 17 CFR § 210.2-01(b) and (c) defining independence requirements for auditors.

75. K.J. Hopt, 'Trusteeship and Conflicts of Interest in the Corporate, Banking, and Agency Law: Toward Common Legal Principles for Intermediaries in the Modern Service-Oriented Society' p. 71–72; v. Simonart, 'Conclusions générales', p. 313.

76. Act of 12 November 1999, Pub. L. 106–102

77. Act of 16 June 1933, ch. 89, 48 Stat. 162.

78. See R.S. Kroszner, 'Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933' (1994) *The American Economic Review* 84, 810–832, showing that the benefits of the separation by no means exceeded the costs they imposed. For a history of the Glass-Steagall Act of 1933 and good review of the literature overturning the underlying conventional wisdom about universal banking see A. Crockett, T. Harris, F.S. Mishkin and E.N. White, *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?*, pp. 56 *et seq.*

79. M. Kruithof, Chapter 10, p. 303 *et seq.*, below.

80. L. Thévenoz, Chapter 11, p. 349 *et seq.*, above.

asset management business from their banking activities into a separate division accounting to the holding company and on an equal footing with bank and insurance activities in the organizational design.<sup>81</sup> This outcome comes surprisingly close to a reinstatement of the Glass-Steagall Act of 1933; the difference being that the command-and-control approach of the New Deal era is replaced by the more contemporary repertoire of incentive-based mechanisms; instead of outright bans, it is now organizational constraints and the costs of compliance that are leading to disaggregated firms.

### C. ORGANIZATIONAL MEASURES

Rather than barring conflicted firms from acting, regulators have increasingly required these firms to manage the problem through organizational measures.<sup>82</sup> Chinese walls, originally designed as a defence against allegations of insider trading, have become a widespread conflict management tool in most financial conglomerates: The separation between the back and front office, between the client trading desk and the firm's proprietary trading desk, are well known and accepted.<sup>83</sup> In the aftermath of recent analyst-related scandals, organizational rules forced institutions to separate analysts from the corrupting influence of investment bankers.<sup>84</sup> There is nothing very new here: effectively this is an extension of Chinese walls to new business lines in integrated firms. However, how best to achieve efficient and reliable Chinese walls is a problem that still needs further research.<sup>85</sup>

In the realm of corporate governance, remuneration committees and independent directors have now become part of the standard palette of institutional measures devised to limit managerial influence on the pay setting policy.<sup>86</sup> But the road to a truly independent executive compensation procedure is still long and arduous. Personal and professional relations cast doubt on apparent independence. In addition, a problem of cognitive dissonance may make directors unduly lenient, thus worsening the problem; in other words, psychological factors induce directors, most of whom are or have been executives themselves, to adjust their perception of reality in favour of the interests of executives.<sup>87</sup>

81. Marc Kruithof, Chapter 10, p. 270 et seq., below; Eddy Wymeersch, Chapter 9, p. 333 et seq., below.

82. See K.J. Hopt, 'Trusteeship and Conflicts of Interest in the Corporate, Banking, and Agency Law: Toward Common Legal Principles for Intermediaries in the Modern Service-Oriented Society', pp. 80–81.

83. Art. 19 (1) and (2) SESA.

84. See e.g. Global Research Analyst Settlement of 2003, <[www.sec.gov/spotlight/globalsettlement.htm](http://www.sec.gov/spotlight/globalsettlement.htm)>; Swiss Bankers Association's Directives on the Independence of Financial Research, <[www.swissbanking.org/en/3566\\_e.pdf](http://www.swissbanking.org/en/3566_e.pdf)>.

85. See e.g. the five-fold test set out by the House of Lords in *Bolkiah v. KPMG* (no. 72 above).

86. See L.A. Bebchuk and C.M. Fried, *Pay without Performance* (Cambridge, MA; London, England, Harvard University Press, 2004), p. 33.

87. See R. Bahar, Chapter 3, p. 96–97, below; L.A. Bebchuk and C.M. Fried, *Pay without Performance* (Cambridge, MA; London, England, Harvard University Press, 2004), p. 33.

The European and Swiss law both require financial groups to carry out their investment fund management activities via a separate entity, which must be clearly segregated from the depository bank.<sup>88</sup> This segregation is far from being complete: most management companies are part of a financial group,<sup>89</sup> and directors of management companies are not independent. Moreover, directors of investment companies are not found at the top levels of group management. Thus, hierarchy and career concerns may temper the autonomy of the company vis à vis the interests of other divisions.

The same criticism can be levelled at the position of the compliance function more generally. We conclude that any conflict management policy must enhance the status of compliance officers and turn them into a core part of the business. During the semester that led to his book, Tamar Frankel sketched the SEC's attempted solution, which is to raise the status of compliance officers by granting them rapid and direct access to SEC staff, a privilege envied by lawyers and management alike.<sup>90</sup> Pushing the organizational strategy to its extreme, the suggestion might be made that all financial companies be required to create a new 'C-Officer': a Chief Conflict Management Officer. She would rank on an equal standing with the chief financial officer or the chief risk officer, which would offer her and her function increased weight within the organization. While this is probably impractical, solutions must be found to put compliance at the top of the value chain.

The problem with rules on management of conflicts of interest is that they smack of a command-and-control approach to regulation, with all the problems that entails, in particular the one-size-fits-all assumption. It would be better to experiment with alternative solutions, which might lead to identifying better institutional arrangements. In addition, if small financial firms were subject to the same rules as larger institutions, they would have to bear comparable compliance costs in absolute terms, which would be disproportionate to the benefits. Thus, in extreme cases, regulation will actually create a barrier to entry for smaller organizations which are arguably less exposed to conflicts of interest.<sup>91</sup>

The classic answer to this criticism lies with self-regulation. By allowing the industry to regulate itself, the legal system avoids some of its traditional pitfalls, including remoteness from market reality and undifferentiated solutions. Self-regulation is based on industry-wide consensus and can produce a higher degree of compliance. However, self-regulation is not without its drawbacks. It lacks the legitimacy based on democratic decision-making, and is prone to regulatory capture and anticompetitive practices. Left to its own devices the industry may be tempted to cater to its own interests rather than those of the investor, particularly the dispersed retail

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88. Art. 9 IFA, confirmed and reinforced by Art. 28(5) of the Federal Act on Collective Investments of Capital of 23 June 2006. Art 5(2) UCITS Directive.

89. Commission Staff Working Paper Annex to the Green Paper on the Enhancement of the EU Framework for Investment Funds, COM (2005) 314 final, p. 21.

90. T. Frankel, Chapter 12.

91. G. Hertig, 'On-Going Board Reforms: One-Size-Fits-All and Regulatory Capture' (2005) *Oxford Review of Economic Policy* 21, 273–275.

investor. Similarly, it can also use the rhetoric of high ethical standards to curtail competitors. As Jean-Baptiste Zufferey hints in his discussion of self-regulation, this may well have been the case with analysts in Switzerland.<sup>92</sup> Lacking any differentiation based on size and specialization, the Swiss Bankers' Association directive was perhaps more a media spin to protect the reputation of global players than the outcome of a sound policy reflection on the problem.

Regulators could, and arguably should, experiment with other forms of regulation. They could, for instance, limit themselves to formulating broad objectives and allow each regulated institution to implement them as it sees fit. Rather than control the specifics of the design, the regulator would then only ensure that the approach was reasonably tailored to its objective, unless major dysfunctions were detected.<sup>93</sup> If a given firm appears to have adopted an inappropriate policy, the regulator would be required to step in and, in extreme cases, impose a standardized set of solutions. This approach, to an extent, underlies several recent regulatory efforts, notably the Basel II Capital Standards, which allows sophisticated institutions to use internal models to measure their credit, market, and operational risks as long as these instruments meet high standards of reliability. Otherwise, standard rules apply.<sup>94</sup>

#### D. DISCLOSURE

As the outright prohibition of conflicts of interest has waned, disclosure has increasingly become the favoured instrument of policy makers. Rather than force a given organizational arrangement on principal and fiduciary alike, as required by most rules on management of conflicts, disclosure seeks to overcome the information asymmetry between the parties. It brings hidden profits and interests out into the light.<sup>95</sup>

This approach is particularly inviting in the area of compensation. No one is arguing any longer for a government-imposed compensation schemes in the financial industry.<sup>96</sup> Competition authorities in Europe and Switzerland have strongly deprecated industry-wide fee setting arrangements.<sup>97</sup> Thus regulation of

92. J. B. Zufferey, Chapter 7, p. 220, below.

93. G. Hertig, 'On-Going Board Reforms: One-Size-Fits-All and Regulatory Capture', pp. 8–10 (2005) *Oxford Review of Economic Policy* 21, 273–275.

94. Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards a Revised Framework' (Bank for International Settlements, Basel: 2004), nos. 756–760.

95. See L. D. Brandeis, *Other People's Money and How Bankers Use It* (New York, 1914; reprint, St. Martin's Press: New York, 1995), p. 89.

96. See K.J. Hopt, 'Trusteeship and Conflicts of Interest in the Corporate, Banking, and Agency Law: Toward Common Legal Principles for Intermediaries in the Modern Service-Oriented Society', p. 70.

97. See e.g. *Kartellkommission*, 'Untersuchung der Kartellkommission: Die gesamt schweizerisch wirkenden Vereinbarungen in Bankgewerbe' [1989] Publications de la Commission suisse des cartels et du Préposé à la surveillance des prix [VKKP], 7 *et seq.*, which set out a far-reaching set of recommendations that to a large extent opened the Swiss banking industry to competition.

the compensation scheme itself is not a viable option, and rightly so. Instead, the focus has been turned on transparency.

At an individual level, disclosure empowers the principal to decide whether or not to do business with a conflicted fiduciary. In the realm of bilateral relations, customers can simply decide not to contract, or to terminate an existing agreement. If they have sufficient bargaining power, customers can try to persuade the fiduciary to take steps to manage the conflict of interest in a more effective way. In the corporate realm, investors can sell their shares and disassociate from a company that does not handle conflicts appropriately. This approach also improves the monitoring of the fiduciary's actions and enables the principal to more easily prove any wrongdoing.<sup>98</sup>

Disclosure also enables the market mechanism to work towards an efficient, albeit less than optimal, solution.<sup>99</sup> The decisions of individual market participants will aggregate into a collective reaction to the conflict of interest, which will factor in the costs and benefits of relying on a conflicted, but competent, service provider. In certain cases, the trade-off will work and customers and investors will opt for this solution. In other situations, customers will simply reject the solution and seek to find an alternative.

In financial markets, most service providers are repeat players who expect to be involved for the long term. Disclosure of past performance thus helps the market to appraise how a fiduciary acted. It also allows the institution to build a reputation for integrity, even in highly conflicted situations. Historically, underwriters, such as J.P. Morgan, were able to instil confidence in investors that they would cater to their interests, even if they themselves were involved in a nexus of opposing interests.<sup>100</sup> Prescribing all-encompassing moral standards and integrity would be impossible. However, disclosure helps to reinforce such social practices by sorting the good types, the 'sugar puffs', from the bad, the 'lemons'.<sup>101</sup>

As one of us (Rashid Bahar) points out, the solution is far from perfect. To be effective, disclosure must be full and complete. However, in a world of increasing commoditization of services, it is not possible to rely entirely on bilateral negotiations to achieve efficient disclosure. The same problem plagues any regulatory approach that does not focus sufficiently on the policy and the pay-performance sensitivity of incentive plans.<sup>102</sup>

98. R. Kraakman, P. Davies, H. Hansmann, G. Hertig, K.J. Hopt, H. Kanda and E.B. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford, Oxford University Press, 2004), pp. 195–196. See also K.J. Hopt, 'Trusteeship and Conflicts of Interest in the Corporate, Banking, and Agency Law: Toward Common Legal Principles for Intermediaries in the Modern Service-Oriented Society', p. 70.

99. See R. J. Gilson and R. Kraakman, 'The Mechanisms of Market Efficiency' (1984) *Virginia Law Review* 70, 552. See also the follow-up article focusing on behavioural finance: R.J. Gilson and R. Kraakman, 'The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias' (2003) *Journal of Corporate Law* 28, 715.

100. D. Skeel, *Icarus in the Boardroom* (Oxford, New York, Oxford University Press, 2005), pp. 57–58.

101. See G. Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism'.

102. See, focussing on the disclosure of executive compensation in Switzerland, R. Bahar, Chapter 3, p. 107, below.

Moreover, the lack of homogeneous requirements hinders any form of inter-firm comparison and thus impedes market discipline. Standardization of disclosure schedules is necessary to minimize transaction costs and to avoid counterproductive information. Through standardization, various actors – investors, creditors, regulators, and academics – can access the information they need directly, rather than be potentially misguided by spin. More importantly, they can compare the performance and policies of firms. But standardization also facilitates the ranking of executive remuneration, which may inflate compensation packages due to a ratcheting effect; the so-called ‘Lake Wobegon’ effect. In other words, any executive can compare her pay-check with those of her peers and demand a raise if hers is below average, i.e. below the market standard.<sup>103</sup>

Like any regulation, disclosure rules may induce certain actors to comply, but they also create opportunities for arbitrage. Less scrupulous actors will seek to hide the most embarrassing information in their disclosure schedules. This is obvious in the context of executive compensation, where management uses equity-based plans and pension schemes as instruments to channel compensation to executives. These payments are troublesome not only because they are not disclosed to investors, but also because they may give false incentives to managers.<sup>104</sup> Although the picture is less bleak with respect to the disclosure of retrocessions, the same risk exists and to a certain extent has taken the form of soft commissions.<sup>105</sup> Thus, although transparency can potentially help, there is no guarantee that it will deliver on all its promises.

Finally, in order for disclosure to achieve its goals, an enforcement mechanism is also required.<sup>106</sup> Several potential solutions are available: a regulatory scheme is but one example. Auditors have long performed this function in the area of financial reporting and underwriters have staked their reputation and liability on the accuracy of offering prospectuses.<sup>107</sup>

Management of conflicts of interest, therefore, may be inevitable: this is the conclusion of most enquiries into executive compensation. Compensation committees and shareholder votes are increasingly being hailed as recommended practices. Even in the fund industry, the formalistic separation between distributors and managers has acquired a new importance in the context of the new interest in ‘fund governance’.<sup>108</sup> Thus, the use of independent managers may perhaps push fund

103. R. Bahar, Chapter 3, p. 118–119, below.

104. *Ibid.*, p. 113–115, below.

105. See T. Frankel, Chapter 12, p. 380–381, below.

106. A. Crockett, T. Harris, F.S. Mishkin and E.N. White, *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?*, p. 8.

107. See R.H. Kraakman, ‘Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy’ (1986) *Journal of Law, Economics, and Organization* 2, 53, 63–66. See more recently in the post-Enron environment, J.C.J. Coffee, ‘Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms’ (2004) *B.U. Law Review* 84, 301, 308–315, A. Hamdani, ‘Gatekeeper Liability’ (2003) *Southern California Law Review* 77, 53.

108. Commission Staff Working Paper Annex to the Green Paper on the Enhancement of the EU Framework for Investment Funds, COM (2005) 314 final, p. 38–44.

management companies to deal with conflicts of interest more adequately. From this perspective, disclosure is one of the numerous tools for managing conflicts of interest. It depends, however, on an external management system: the market or the individual actors should be able to use the information provided to them. They should, thus, be able to appraise whether it is worth putting their trust in the conflicted agent and whether the internal controls set up to avert any adverse consequences exist and are effective.

#### IV. ENFORCEMENT

Thanks to the American legal realists,<sup>109</sup> the dichotomy between ‘law in action’ and ‘law in the books’ is well known. Conflicts of interests in the financial industry provide a striking example of this problem. In theory, the legal doctrines are relatively well established, however, there is something of a chasm between the legal nirvana of conflict of interest rules and the harsh reality of everyday practice. This dichotomy is mainly attributable to enforcement. It does not imply that law must yield to reality. However, legal policies must be realistic and policy makers need to think how they will implement their advice to ensure it is effective in practice.

##### A. PRIVATE LAW REMEDIES OF THE PRINCIPAL

The main problem with the enforcement of conflict of interest rules stems from the very nature of the duty of loyalty. Compliance with this duty cannot be directly observed; at best it can be guessed at through proxies. Thus, a first set of rules attempts to facilitate the enforcement efforts of principals by introducing a number of presumptions. Early on fiduciary law set out a presumption of breach of loyalty and a heightened standard of review whenever an agent was acting in a conflicted situation: the agent had to prove the intrinsic fairness of her actions so as not to be held in breach. Although common law jurisdictions have formulated this doctrine in its strictest form,<sup>110</sup> milder versions also exist in civil law jurisdictions. Thus, for instance, Swiss corporate law recognizes that the business judgment rule no longer applies in situations in which a conflict of interest creates the suspicion that directors or officers did not act in the best interest of the corporation.<sup>111</sup>

109. See e.g. Roscoe Pound, ‘Law in Books and Law in Action’ (1910) *American Law Review* 44, 12, 18.

110. See § 4.01 (c) American Law Institute Principles of Corporate Governance; *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) 812; *Smith v. Van Gorkom*, 488 A. 2d 858 (Del. 1985).

111. See e.g. SJ 1982 221, c. 3a, 225 ; ATF 113 II 52, c. 3a, 57. L. Glanzmann, ‘Die Verantwortlichkeitsklage unter Corporate Governance-Aspekten’ *Revue de droit suisse* 119 (2000) II 135, 165–166, A.R. Grass, ‘Management-Entscheidungen vor dem Richter: Schranken der richterlichen Überprüfbarkeit von Geschäftsentscheiden in aktienrechtlichen Verantwortlichkeitsprozessen’ *Revue suisse de droit des affaires* 72 (2000) 1–10, A. R. Grass,



Beyond the level of scrutiny exercised by courts, remedies play a decisive role in the effective enforcement of conflict of interest rules. In this respect, common law jurisdictions have a decisive advantage over civil law. Grounded in the language of property law, Anglo-American fiduciary law allows the wronged principal not only to sue for damages, but also to force the fiduciary to disgorge any undue profits. As law and economics scholars have pointed out, this remedy debars the fiduciary from making any profit at the expense of the principal and thus creates appropriate incentives for the principal to fulfil his obligations.<sup>112</sup> Although, in certain continental jurisdictions, a disgorgement-type remedy is in theory available under the title of unjust enrichment<sup>113</sup> or the Swiss *gestion d'affaires sans mandat*,<sup>114</sup> continental legal systems seem to lack a doctrinal foundation for recognizing a generalized right to disgorgement.<sup>115</sup> In any case, this right lacks any bite in practice, probably because lack of information and procedural hurdles make the right difficult to enforce.

## B. CLASS ACTIONS AND DERIVATIVE SUITS

The classical remedies of private law fail to deliver either in the corporate world or in the financial industry. The costs of litigation are too high for most private investors. Civil actions are confined to the more affluent institutional investors and high net worth individuals and are beyond the reach of most retail investors, because the costs of litigation would exceed the possible benefits.<sup>116</sup> Collective action problems and rational apathy accentuate this problem in the corporate environment. An individual

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*Business Judgment Rule: Schranken der richterlichen Überprüfbarkeit von Management-Entscheidungen in aktienrechtlichen Verantwortlichkeitsprozessen* (Zurich, Schulthess, 1998); Trigo Trindade and Bahar, 'Droits des actionnaires minoritaires en Suisse', p. 396, H.C. von der Crone, 'Auf den Weg zu einem Recht der Publikumsgesellschaften' *Revue de la société des juristes bernois* 133 (1997) 73, 107; P. Widmer and O. Banz, in *Basler Kommentar zum Schweizerisches Privatrecht*, N. P. Vogt, R. Watter, and H. Honsell (eds) (Basle, Geneva, Munich, Helbing & Lichtenhahn, 2002) ad art. 754 CO, no. 31.

112. R. Cooter and B.J. Freedman, 'The Fiduciary Relationship: Its Economic Character and Legal Consequences' (1991) *New York University Law Review* 66, 1053–1056.

113. Art. 62 CO.

114. Art. 423 CO.

115. See K.J. Hopt, 'Trusteeship and Conflicts of Interest in the Corporate, Banking, and Agency Law: Toward Common Legal Principles for Intermediaries in the Modern Service-Oriented Society', p. 85. For an attempt to identify a general disgorgement theory within a continental legal system, see C. Chappuis, *La restitution des profits illégitimes: le rôle privilégié de la gestion d'affaires sans mandat en droit privé suisse* (Basle, Frankfurt, Geneva, Helbing & Lichtenhahn, 1991); C. Chappuis, 'La remise du gain: les temps sont mûrs' in *Quelques questions fondamentales du droit de la responsabilité civile*, F. Werro (ed.) (Bern, Staempfli, 2002) p. 51; C. Chappuis, 'La restitution des profits illégitimes, le retour' in *De lege ferenda: réflexions sur le droit désirable en l'honneur du professeur Alain Hirsch*, A. Héritier-Lachat and L. Hirsch (eds) (Geneva, Slatkine, 2004), p. 341.

116. See, in relation to consumers in competition law, the Green Paper Damages Actions for Breach of the EC Antitrust Rules (2005), p. 9.

shareholder will not invest in monitoring and litigation if she can free-ride on the efforts of other players.<sup>117</sup>

Thus the level of enforcement obtained through traditional routes is bound to be suboptimal. To overcome this hurdle, legal systems have experimented with a number of procedural strategies. Derivative suits and class actions create the preconditions for litigation entrepreneurs to take the enforcement of rules into their own hands: such procedural institutions enable a lawyer to act in the interests of a diffuse mass of affected persons. This system has been grafted on to private law and does not modify the core set of substantive rules on conflicts of interest. Interestingly, it also assumes that the legal system will enable lawyers to play a more entrepreneurial role by permitting payment schemes based on contingent fees.<sup>118</sup>

From a policy perspective, the chief effect is to improve the effectiveness of sanctions. Moreover, it diminishes the administrative costs of numerous lawsuits by consolidating them all into a single venue. This strategy has a major downside: civil procedure remains a costly means of enforcement and the 'one case at a time' approach may arguably lead to inconsistency.<sup>119</sup> Moreover, litigation entrepreneurs usually lack the more specialized information required to pursue a broader policy of enforcement.<sup>120</sup> Finally, the entire system may be taken hostage by opportunistic suits, where one shareholder or shareholder's attorney tries to hold out unless a company it is willing to settle.<sup>121</sup>

### C. CRIMINAL LAW

Traditionally, if private action is lacking but a public interest is involved, there is a call for deterrence through the criminal justice system. A public prosecutor can call to account and punish misfeasors<sup>122</sup> using a wide array of legal mechanisms. In addition to the monetary sanctions, such as damages and disgorgement, and to injunctions, criminal law enables the legal system to act upon persons who would otherwise evade its grasp.<sup>123</sup>

117. See e.g. R. Kraakman, P. Davies, H. Hansmann, G. Hertig, K.J. Hopt, H. Kanda and E.B. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, p. 116–119.

118. E.g. *ibid.* See also J.C. Coffee, Jr., 'The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation' (1985) *Law & Contemporary Problems* 48,5; R. Romano, 'The Shareholder Suit: Litigation without Foundation' (1991) *Journal of Law, Economics, and Organization* 7, 55.

119. See in relation to product liability law R. Epstein, *Simple Rules for a Complex World* (Cambridge, MA, London, Harvard University Press, 1995) pp. 240–243. See in relation to competition law the Green Paper *Damages Actions for Breach of the EC Antitrust Rules*, p. 9.

120. R. Epstein, *Simple Rules for a Complex World*, p. 243.

121. See D.R. Fischel and M. Bradley, 'Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis' (1985) *Cornell Law Review* 71, 271–274.

122. See K.J. Hopt, 'Trusteeship and Conflicts of Interest in the Corporate, Banking, and Agency Law: Toward Common Legal Principles for Intermediaries in the Modern Service-Oriented Society', p. 85.

123. S. Shavell, *Foundations of Economic Analysis of Law* (Cambridge, MA, and London, Harvard University Press, 2004) p. 510. See also more generally S. Shavell, 'Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent' *Columbia Law Review* 85 (1985) 1232.

Due to the gravity of these sanctions, criminal law calls for a heightened burden of proof and is only suitable for the most severe and egregious breaches of loyalty. However, as the Global Research Analyst Settlement of 2003<sup>124</sup> has shown, this approach can strongly impact the financial world. Nevertheless, although it may deter fiduciaries from committing the worst violations, this approach is unsuitable to tackle minor breaches.

#### D. REGULATORY ENFORCEMENT

The last, although probably the most popular alternative strategy to private enforcement by the principal is regulation – including supervised self-regulation. This approach avoids the pitfalls of civil procedure and criminal law. The centralized enforcement authority can monitor the market as a whole. Obviously, the authority will lack information on specific violations, but at the very least it can focus on the big picture with the assistance of a specialized staff with dedicated resources. In this way, the authority can monitor compliance with broad policy purposes and tackle systemic dysfunctions.<sup>125</sup>

We noted this advantage previously in the rule-making arena, but the advantage is even more significant in the area of enforcement. Thanks to the inexpensive enforcement mechanisms provided by administrative law, it can ensure a certain degree of standardization. As one of us points out in his paper, the SEC had to provide tabular forms in order to ensure that investors could compare the disclosure of executive compensation packages. Such a rule is not significantly more costly to apply than a general duty to disclose compensation packages, but it nonetheless enables the enforcement authority to ensure from a superficial inquiry that issuers comply with the rule. Investors ultimately benefit from standardized information which they could not have obtained otherwise.<sup>126</sup> In Switzerland, individual investors could arguably have obtained the information disclosed in the corporate governance schedules prior to the enactment of the rules. Investors, however, were noticeably silent. It was left to the Federal Banking Commission to pressure the Stock Exchange into adopting a mandatory scheme for the disclosure of executive compensation.<sup>127</sup>

Moreover, administrative law can enforce precautionary rules before any harm is done, thus playing a key role in preventing violations and maintaining trust in the markets – as well as restoring trust in the aftermath of a scandal.<sup>128</sup> This advantage is

124. Global Research Analyst Settlement of 2003, <[www.sec.gov/spotlight/globalsettlement.htm](http://www.sec.gov/spotlight/globalsettlement.htm)>.

125. See Shavell, 'The Optimal Structure of Law Enforcement', pp. 590–598; R. Kraakman, P. Davies, H. Hansmann, G. Hertig, K.J. Hopt, H. Kanda and E.B. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, p. 211. See also, in the context of product liability, R. Epstein, *Simple Rules for a Complex World*, pp. 236–237.

126. R. Bahar, Chapter 3, p. 110–112, below.

127. Rapport de gestion CFB 2000, 213; Rapport de gestion CFB 2001, 221. This eventually led to the implementation of the Corporate Governance Directive.

128. S. Shavell, 'The Optimal Structure of Law Enforcement', pp. 590–598.

particularly interesting in the area of conflicts of interests, as the breach of loyalty itself is hard to detect. For instance, formal rules on Chinese walls are easy to monitor, whereas the information flow itself is difficult for even a regulator to supervise, let alone a customer.

However, as with rule-making, micro-management by the regulator remains a notable drawback of public enforcement.<sup>129</sup> Conversely, with an increasing volume of regulations, regulators are bound to prioritize their enforcement efforts. As a result, certain rules are likely to remain on the books without ever being acted upon. Although all rules ideally have an equal standing, in a world of limited resources, the phenomenon is inevitable. This development sets a new challenge for policy makers and regulators: Rather than refuse to acknowledge reality, they ought to acknowledge this prioritization and explain it following a rational process, such as cost-benefit analysis or another methodology.

## V. CONCLUSION

Conflicts of interest lie at the heart of modern financial architecture; an architecture which is based on increasing intermediation. Conflicts of interest can potentially arise every time an intermediary acts for the benefit of a third party to whom she owes a duty of loyalty, if the agent has a personal interest in the transaction or acts also on behalf of persons who themselves have a vested interest. As the network of relations becomes increasingly dense, the likelihood of such conflicting interests increases. This development challenges the classical legal framework in both common law and civil law jurisdictions, which seeks to avoid conflicts of interest.

Traditionally, this issue was tackled by private law, and more specifically by property and contract law. After the Great Depression, most Western democracies looked to regulation and administrative law to deal with instances of conflicts of interests. Regulation and supervision have become increasingly significant in financial industries. The pace of reform has increased in the European Union in order to foster the creation of an integrated financial market. Switzerland, while not participating in this grand effort, has mirrored these developments. Throughout the world, the scandals that accompanied the end of the stock exchange bubble of the 1990s merely served to accelerate the trend.

This thickening of the legal framework is not devoid of ambiguity. In parallel with this phenomenon, market participants have sought to relax the core duty of loyalty. The commoditization of financial services and the increased horizontal integration of market-players has made this phenomenon unavoidable. Is it realistic to require the same degree of independence from an investment banker in a global marketplace dominated by ten players as from a trustee in a pre-industrial society,

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129. G. Hertig, 'On-Going Board Reforms: One-Size-Fits-All and Regulatory Capture', (2005) *Oxford Review of Economic Policy* 21, 273–274.

especially if we expect the banker to be experienced and aware of the latest developments in the industry? Innovations such as execution-only brokers and other efforts to narrow down the service provided are just one manifestation of this effort.

The complexity of the problem is also obvious with regard to remedies to conflicts of interest. A pure *laissez-faire* policy is not appropriate. Market pressure is not a panacea that can solve all problems related to conflicts of interest. Weak or imperfect competition caused by market structures, transaction costs and information asymmetry prevents this mechanism from disciplining agents. However, prohibiting them to act in conflicted situations is far too radical. It bars principals from using a conflicted but qualified agent in circumstances in which expertise is more important than loyalty. Regulators have therefore increasingly relied on organizational measures to solve the problem, which had the result of creating a new problem: namely how to reconcile this command-and-control approach with the organizational autonomy that market-players need if they are to adapt to their rapidly changing environment, without considering the subtle interaction between regulation and competition? This is why disclosure was hailed as an ideal remedy. However, disclosure also has its dark side. Its effectiveness, for example, relies on standardization. Moreover, disclosure, like any type of intervention, opens the gate to regulatory arbitrage that may have perverse effects. In fact no system is perfect, although an approach based on light organizational rules and clear disclosure schedules is arguably the best option.

But the formulation of an adequate remedy for conflicts of interest is only a partial solution to this problem. The real issue is enforcement. To postulate a duty of loyalty is simple; to ensure compliance is a far more strenuous task. Starting from private law remedies available to the principal, we observed various attempts to overcome the high costs of private litigation, ranging from class actions and derivative suits to criminal law and regulatory enforcement. Each attempt creates new challenges: how to coordinate private actions into a consistent policy; how to overcome the risk that regulators focus on minor issues and micro-manage an industry while missing the bigger picture; and so on. This calls for the formulation of new policies and methodologies to assess the effectiveness of enforcement techniques and further research.

Conflicts of interests are here to stay and the challenges they pose are increasingly complex. Despite the numerous developments of the past ten years, as this book demonstrates, there is still a long way to go. We hope that this book will help guide policymakers, scholars and practitioners as they attempt to formulate answers to problems old and new.

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