Guidelines for the Regulation of Conflicts of Interest Facing Market Intermediaries

Final Report

EMERGING MARKETS COMMITTEE
OF THE
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Chapter 1 Executive Summary

The last few years have seen a significant growth in the involvement of market intermediaries in the financial market, which has led to increased complexity in the range of business services provided as well as the usage of financial products and instruments. The recent financial crisis and several corporate scandals have given rise to concern over the conduct of market intermediaries due to their inherent agency structure that gives rise to conflict of interests. Many cases have arisen where intermediaries are not acting in the best interests of their clients. Further, due to providing a wide range of services, market intermediaries are prone to conflicts of interest, which can lead them to diverge from adopting strategies and behavior to benefit their clients.

The evolving market scenario combined with an enhanced role of globalization in financial markets has prompted regulators to find improved regulations to address conflicts of interests faced by market intermediaries which pose a risk to the health of any financial system. There are apprehensions over the methods and strategies adopted for the regulation of market intermediaries to manage conflict of interests. Regulators have been criticised by various sections for using soft regulation in relation to market intermediaries[1]. The increased role of globalization in the financial markets has also led to circumstances which have called for greater alignment in the regulatory scope of different jurisdictions. Therefore, regulation of financial markets needs to be developed with a focus on commonly accepted rules for the regulation of conflicts of interest. Consequently, an increasing number of the members of the International Organization of Securities Commissions (IOSCO) are in the process of adopting new regulations, to target conflicts of interest.

The Emerging Markets Committee (EMC) meeting held on 5 November 2009, mandated the Emerging Markets Committee's Working Group 3 (EMCWG3) on Supervision of Market Intermediaries to develop, for emerging markets regulators, *Guidelines for Regulation of Conflicts of Interest Facing Market Intermediaries*.

Market intermediaries provide a range of services and are hence placed at an informational advantage over other players in the financial market. Imperfections in the financial market and asymmetry of information are the prime reasons which can lead to the exploitation of conflicts of interest by market intermediaries. Difficulties with the regulation of conflicts of interest faced by market intermediaries arise due to problems in identifying all the situations which can cause a conflict. Robust regulation of conflicts can take away the advantages a market intermediary possesses through the means of economies of scope. On the other, hand light touch regulation will create an incentive for intermediaries to exploit their clients, which would lead to a loss in investor confidence. Therefore, the regulatory framework should create a balance between the two and most importantly aim to affect the behavior of the management of an intermediary through emphasizing the importance of adopting strict internal control measures to avoid conflicts of interest from arising.

This report examines the role of market intermediaries in financial markets and highlights different scenarios where conflicts of interest can take place. The report goes on to identify

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1 www.financialpolicy.org/DSCEatwell.pdf;
www.unctad.org/templates/Download.asp?docid=11243&lang=;
www.ibanet.org/Document/Default.aspx?DocumentUid=8EC32CFD.

remedies and create suitable guidelines which can be used by EMC jurisdictions for better management of conflicts of interest.

Chapter 2 Purpose, Scope and Methodology of the Report

A. Purpose of the Report

The purpose of this report is to develop guidance for IOSCO EMC member jurisdictions for efficient regulation of the conflict of interests facing market intermediaries, to protect the interests of investors and ensure proper management of risk, in line with IOSCO's *Objectives and Principles of Securities Regulation*[2] Principle 31[3] that requires market intermediaries to establish an internal function that delivers compliance with standards for internal organization and operational conduct. This report builds on previous work undertaken by the IOSCO Technical Committee which has analyzed conflicts of interest which arise in particular services offered by market intermediaries[4].

Market intermediaries provide many different services within financial markets; hence many scenarios exist where the market intermediary could be faced with a conflict of interest. In particular, full-service investment firms providing a full range of services including brokerage, market making, investment banking and asset management have a greater likelihood of facing conflicts of interest, regardless of whether these services are offered through in-house or affiliation.

Conflicts for an intermediary can exist with a client as well as between groups of clients. Asymmetric information[5] available to the intermediary is the root cause of these conflicts. As an intermediary possesses information from a number of clients or investors it has an informed advantage over its clients. This can lead to situations where a department or business unit within the intermediary would benefit more than a different part or department of the intermediary, or a situation where the intermediary prefers certain clients over others with the hope of receiving further business in the future. The conflicts of interests between

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2 *Objectives and Principles of Securities Regulation, June 2010 available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf.

These consist of 38 Principles of securities regulation (including, the 8 new principles which have been added in June 2010) which are based upon three objectives of securities regulation: protecting investors; ensuring that markets are fair, efficient and transparent; reducing systemic risk.

3 IOSCO Principle 31 of the *IOSCO Objectives and Principles of Securities Regulation* for market intermediaries states the following:

"Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters."

4 *Market Intermediary Management of Conflicts that arise in Securities Offerings*, Final Report, Report of the Technical Committee of IOSCO, November 2007 available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD257.pdf.;

Report on Analyst Conflict of Interest, Report of the Technical Committee of IOSCO, September 2003 available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD152.pdf;

Conflicts of Interest of CIS Operators, Report of the Technical Committee of IOSCO, May 2000 available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD108.pdf;

Private Equity Conflicts of Interest, Consultation Report of the Technical Committee of IOSCO, November 2009 available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD108.pdf;

5 Asymmetric information refers to an imbalance of information when dealing with multiple parties.

brokerage and dealing, asset management and other securities businesses, and corporate finance services and other securities businesses are specifically highlighted in this report.

The report is divided into following five parts:

1. Structure of market intermediaries and conflict of interest that exists (role of market intermediary and why conflicts arise, Type 1 and Type 2 conflicts, firm client conflicts, conflicts between different clients and conflicts between different departments or business units of an intermediary);

2. Regulatory framework used in EMC jurisdictions to deal with conflicts of interest (internal control system, disclosure, suspension of transactions, information barriers between departments and affiliates and a review committee for conflicts);

3. Regulation for different types of conflicts of interest that exist (between corporate finance services and other securities businesses, asset management services and other securities businesses, brokerage and dealing);

4. Guidelines and suggestions for better regulation of conflicts of interests. This also covers areas which EMC jurisdictions feel are common and most significant in the context of conflicts of interests; and

5. Conclusion and way forward.

B. Scope of Study Conducted

The EMC's research covers the supervisory framework used by EMC member jurisdictions to address conflict of interests and focuses on the following activities of market intermediaries:

- Brokerage and/or proprietary trading;

- Securities offerings and other investment banking services; and

- Asset management business, separately or in combination with other securities services.

For the purpose of this study, the following terms:

Regulators – refers to regulators of the capital market activities particularly those activities listed in above paragraph;

Market intermediaries - means the securities firms carrying out financial investment services such as brokerage, dealing, asset management service, etc., regardless of the type of financial products. The market intermediary could also provide corporate finance services such as IPO underwriting and merger and acquisition (M&A) consulting. The range of permissible businesses may differ from jurisdiction to jurisdiction depending on their legal frameworks;

Brokerage - means purchasing and selling securities in the secondary market for another person's account regardless of the title thereof;

Dealing - means purchasing and selling securities in the secondary market for its own account regardless of the title thereof. The term *dealing* in this survey does not include corporate finance services defined below;

Asset management service - means operating funds raised from more than one investor without any control by investors over the investment decision, and distributing benefits of the investment. For jurisdictions that separate the collective investment schemes (CIS) distributor from the CIS operator, the term *asset management service* in this survey includes CIS distribution; and

Corporate finance service - refers to the financial services related to the capital structure of a company. It may include underwriting IPO securities in the primary market, business of arranging for and intermediating the M&A of companies, or acting as an agent for that purpose, business of providing advisory services on the M&A of companies, or business of managing properties of a private equity company. The range of permissible businesses may vary from jurisdiction to jurisdiction depending on their legal frameworks.

C. Assessment Methodology

A survey questionnaire was circulated amongst the EMC member jurisdictions to obtain feedback to analyze their practices and key features of their regulatory regimes governing the conflicts of interests facing market intermediaries. The survey was divided into the following four sections:

i. Business structure of market intermediaries;

ii. Regulatory framework for preventing conflict of interests;

iii. Regulations for different types of conflict of interests; and

iv. Practical considerations and actions for regulatory improvement.

D. Surveyed Jurisdictions

The EMC would like to acknowledge EMC members from the following jurisdictions for providing valuable information pertaining to their jurisdictions:

S.No.	JURISDICTION	REGULATORY AUTHORITY
1.	Argentina	Comisión Nacional de Valores
2.	Bermuda	Bermuda Monetary Authority
3.	Brazil	Comissão de Valores Mobiliários (CVM) Brazil
4.	British Virgin Islands	British Virgin Islands Financial Services Commission
5.	Cayman Islands	Cayman Islands Monetary Authority
6.	Chinese Taipei	Financial Supervisory Commission
7.	Colombia	Superintendencia Financiera de Colombia (SFC)

8.	Dubai International Financial Centre (DIFC)	Dubai Financial Services Authority (DFSA)
9.	India	Securities and Exchange Board of India (SEBI)
10.	El Salvador	Superintendencia de Valores
11.	Jordan	Jordan Securities Commission (JSC)
12.	Korea	Financial Supervisory Service, Korea
13.	Malaysia	Securities Commission Malaysia (SC)
14.	Montenegro	Securities Commission of the Republic of Montenegro
15.	Nigeria	Securities and Exchange Commission (SEC)
16.	Oman	Capital Market Authority (CMA)
17.	Pakistan	Securities and Exchange Commission of Pakistan (SECP)
18.	Panama	Comisión Nacional de Valores (CNV)
19.	Romania	Romanian National Securities Commission (RNSC)
20.	South Africa	Financial Services Board (FSB)
21	Sri Lanka	Securities and Exchange Commission (SEC), Sri Lanka
22.	Thailand	Securities and Exchange Commission (SEC)
23.	Turkey	Capital Markets Board (CMB)
24.	United Arab Emirates.	Emirates Securities and Commodities Authority (SCA), UAE

E. Introduction

Market intermediaries range in size from two people firms to multinational businesses and may carry a business offering limited services and products, or multiple businesses offering a variety of services and products. Market intermediaries can provide many different financial services such as brokerage, dealing, asset management and corporate finance or affiliate with other market intermediaries providing different financial services. These market intermediaries are extremely prone to conflicts of interests as they can deal in more than one function for a particular client or a group of clients.

Conflicts between a firm and client are normal in business as both look to increase their wealth. Conflicts do not always need regulation but in situations where a firm is providing multiple services to a client, the firm could have an incentive of providing false or misleading information to the client for its own benefit. The synergies created through combining multiple activities within a financial institution, is one of the driving forces behind the development of financial institutions. However, increasing sophistication and synergies can lead to the development of conflicts of interest within a firm. Financial institutions need to be aware of this risk and need to develop systems to manage any conflicts of interest accordingly.

In most jurisdictions surveyed, market intermediaries are allowed to operate in multiple businesses simultaneously. The structure of intermediaries differs from jurisdiction to jurisdiction according to the complexity of their capital markets and legal structure. All jurisdictions in the survey responded that intermediaries were involved in brokerage and dealing. Almost all jurisdictions permit intermediaries to undertake corporate finance services. Furthermore, asset management services were undertaken by intermediaries in the surveyed jurisdictions. Conflicts of interest arising from concurrently undertaking these services will be highlighted in Chapter 3 of this report.

Chapter 3 Conflicts of interest

Conflict of interests are a fundamental and pervasive issue both in developed and emerging capital markets where transactions between the market participants are primarily assisted by market intermediaries. Market intermediaries in primary and secondary capital markets have to balance their own interests, the interests of their partners and those of issuers and investors. Conflicts of interest usually arise due to an imbalance of information between two or more parties. Reliable information is a necessary tool for markets to serve their purpose efficiently. Asymmetric information between different parties creates the possibility where the party with access to more reliable information can take advantage of the situation. Asymmetry of information such as in the case where a business manager is better informed about his firm's risks and returns as compared to a purchaser of the firm's securities, can lead to problems faced through adverse selection[6] and moral hazard[7].

A. Definition of Conflicts of Interest

The term conflict of interest is widely used in commercial and legal transactions and is acknowledged in the codes of ethics of various professional bodies, to identify behavior that is unacceptable. Despite international usage of the term, there is no universally accepted definition of conflicts of interest. To further accentuate the problem, the globalization of the world's financial markets has led to different definitions and regulations of what constitutes a conflict in different jurisdictions. Conflicts of interest are normally attributed to imperfections in the financial markets and asymmetric information.

Previous work by IOSCO[8] has dealt in regulating conflicts of interest in various areas of the capital market but has not provided a general definition of what constitutes a conflict of interest. Similarly the European Union (EU) has established a number of rules regarding situations where a conflict of interest arises in the capital markets but has so far abstained from a general definition[9]. Not all conflicts of interest create market failures i.e. where the transacting parties are unable to find appropriate contractual solutions themselves, hence only those conflicts that can result in market failure should be addressed. Most jurisdictions surveyed responded that they did not have a legal definition of what constitutes a conflict of interest in place, but for the sake of this report a conflict of interest is said to arise when the interests of particular firms and investors are pursued at the expense of other firms and investors.

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6 A situation where sellers possess information that buyers don't, leading to inappropriate selection.

7 The risk that a party to a transaction has not entered into a contract in good faith.

8 *Market Intermediary Management of Conflicts that arise in Securities Offerings*, Final Report,Report of the Technical Committee of IOSCO, November 2007 available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD257.pdf;

Statement of Principles for addressing sell-side Securities Analyst conflicts of interest, Statement of the Technical Committee of IOSCO, September 2003 available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD150.pdf; and

Conflicts of Interest of CIS Operators May 2000.cf note 6 above;

9 The EU Commission Directive 10 Aug, 2006. Implementing Directive to EU "Markets in Financial Instruments Directive (MIFID), April 2004".

B. Classification of Conflicts of Interest

Situations creating a conflict of interest could occur between a company and a client (type 1 conflict), between different groups of clients (type 2 conflict) and also within an organization, team or department (intragroup conflict). Not every mentioned conflict affects all institutions, the size and nature of the conflict varies depending on the complexity of the business structure in place at the institution. The different types of conflicts of interest that can arise are described below:

B.1 Firm/Client Conflicts

Type-1 conflicts take place 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. A firm holds an informational advantage over its clients, which can lead to the firm not necessarily working in the client's best interest. In addition to direct firm-client conflicts, indirect conflicts such as collusion between the firm and a fiduciary acting as an agent for the client could also exist. Market intermediaries, due to the various services offered, may provide the information made available to them by a client to benefit their proprietary trading desk rather than the client. Such conflicts can also arise where the intermediary takes part in an underwriting for a business and on the other hand is also a commercial lender to the same business. This could lead to false and misleading advice being provided to the client, hoping that the money made from the underwriting will be used to clear the debt the business owes to the intermediary.

B.2 Client/Client Conflicts

Type-2 conflicts are present between a firm's clients or types of clients, which place the firm in a position of favoring one client at the expense of another. Such situations arise as not all investors are on an equal informational footing. Institutional investors often expend resources on research purposes, giving them an advantage over individual investors who typically lack the ability to engage in the same level of research. When the intermediary deals with several clients it is under no obligation to serve one client over the other, therefore it could lead to a situation where it prefers one client over the other due to a promise of future business or better business relationships. Such a case could take place where a securities offering is oversubscribed and the intermediary provides preferential treatment to certain clients. A more serious conflict can arise in a situation where clients of the intermediary are on different market sides. If an intermediary serves different clients who are issuers and investors respectively, a conflict could arise in the pricing of the offer as the issuer could want a higher price to be set in order to maximize his income, while the investor would want to purchase the securities at a reasonable price.

B.3 Intra Group Conflicts

Intra group conflicts in this case refer to the incompatibility, incongruence, or disagreement between members, business units or departments of an intermediary or between subsidiaries or branches of an internationally active financial group across jurisdictions regarding their goals, functions or activities. A simple example of this could be that an internationally active financial group's management decisions may be in the best interest of the group but at the expense of loss of profits, costs or other sacrifices on the side of their subsidiaries or branches. If this is the case, there is a reasonably high likelihood that interests of the group's clients in one jurisdiction may be sacrificed for the benefit of its clients in other jurisdiction(s). In more complex situations a financial intermediary undertaking different services will not always work in the best interest of all departments or affiliates. A transaction which could be beneficial for one service area of the intermediary could be detrimental for the other. In general, intra group conflicts may be discussed as part of discussions on Type-1 and Type-2 conflicts above, as they are mostly triggered by the intention of an intermediary or an internationally active financial group to place its own benefits over those of their clients and may be effectively prevented where its subordinate business entities or units are treated equally in accordance with clearly stipulated standards governing the entire intermediary or group.

C Regulatory Framework for Preventing Conflicts of Interest

The growing number of recent corporate scandals suggests that markets are inefficient and that new regulations are needed to prevent any further loss of investor confidence in the financial system[10]. Regulation of conflicts of interest needs to find a balance between over and under regulation. Inadequate regulation can result in costly failures while over-regulation can prove detrimental to the financial industry through a cautious approach by both investors and intermediaries. The grounds for regulation of conflicts of interest vary from jurisdiction to jurisdiction depending on legal requirements in place. Regulation of conflicts of interest can be stated in statutes made by the legislature, supervisory regulations issued by securities regulators or other government agencies and industry rules or guidelines issued by Self Regulating Organizations (SRO). In a few jurisdictions where there were no regulatory grounds to control conflicts, market intermediaries have made their own rules to deal with conflicts of interest for their internal control purposes.

In all the jurisdictions surveyed conflicts of interest facing market intermediaries were governed through regulations issued by the securities regulator or government agencies while half of the jurisdictions governed conflicts through statutes made by the legislature or via guidelines issued by SRO's. The securities regulator has the authority to regulate conflicts of interest in all the countries surveyed while SRO's were also able to regulate conflicts in some jurisdictions. General principles such as prohibition of conflicts of interest, duty of care and duty of loyalty are covered by the regulations in place in most jurisdictions surveyed while the laws and regulations in place in other jurisdictions account for more specific provisions depending on the nature of the conflict at hand.

Several different strategies can be adopted in order to effectively address the problems posed to market intermediaries by conflicts of interest. As market intermediaries are prone to conflicts of interest due to their structure, the primary strategy would involve the creation of an organizational structure which prevents or minimizes conflicts of interest from taking place and focuses on altering the behavior of different players within the intermediary so that it works in the best interest of its clients. For an appropriate organizational structure to be put in place for market intermediaries, different measures can be put in place by jurisdictions. Most jurisdictions surveyed rely on a mix of strategies which are set out below:

10 "Can the Market Control Conflicts of Interest in the Financial Industry" Eugene N. White, May 2004.

C.1 Disclosure of Conflicts

Disclosure is an extremely popular procedure used by jurisdictions to address conflicts of interest. In situations where a conflict arises within an intermediary and it is unable to ensure fair treatment towards the client, disclosure of the conflict should be made mandatory in order to allow the client to make an informed decision. However, mandatory disclosure may be insufficient as intermediaries may hide relevant information. In order for disclosure to be effective and meaningful for the client it needs to be complete and timely, taking into account all aspects where a conflict can arise. Effective disclosure reduces information asymmetries between different parties in a transaction and protects against the problems posed by adverse selection and moral hazard. Nonetheless, disclosure is a complex strategy and intermediaries usually underestimate the risk of a conflict arising, leading to a lack of disclosure to their clients. As a result, some supervisory oversight may be needed, since regulators can observe information regarding firms' conflicts of interest and can take actions to prevent intermediaries from exploiting conflicts of interest.

C.2 Information Barriers

Information barriers (Chinese Walls) are used in several of the jurisdictions surveyed to mitigate the risk posed by conflicts of interest. Information barriers are used in firms to block or hinder the flow of information from one department to another. This is important for market intermediaries due to their complex structure for e.g. an information barrier could be set up between the research division in an intermediary and the investment banking division, as the research department could produce a biased report on a company whose underwriting is being done by the intermediary. For information barriers to properly take affect it is essential that the procedures are clearly defined so that only the concerned divisions have access to any information that is deemed confidential. Information barriers can be of a physical nature such as separation of different departments from one another or they could involve classification of documents and computer security protections. However, intermediaries need to be careful while setting up information barriers since stringent separation of functions through barriers can seriously reduce synergies of information collection, thereby preventing intermediaries from taking advantage of economies of scope in information production.

C.3 Limitation/Prohibition of Business Conduct

Nearly all the jurisdictions surveyed impose limitations on business conduct. When a conflict arises and an intermediary feels that it cannot be dealt with even after disclosure of the conflict to the client, the intermediary should refrain from acting, therefore protecting its customer from issues created by the conflict. Intermediaries should also refrain from acting where the conduct is prohibited in the law. Limitations on business conduct should be placed with great care as it could have negative implications in the market, due to investors seeing this as a bottleneck or viewing this as a hindrance towards investing in the concerned firm. The procedures defined for imposing limitations on business conduct need to be properly defined for this strategy to work properly. An intermediary should be able to identify and realize situations where it will not be able to work in the best interest of its client. This strategy should only be used as a last resort.

C.4 Self Control and Firm's Internal Conflict of Interest Management

Many jurisdictions rely on intermediaries to be able to manage the conflict of interest internally. This strategy depends on a market intermediary and its management being aware of situations where a potential conflict of interest can take place. Most intermediaries are divided into different business units where each unit functions as a sole business. For this strategy to be implemented adequately it is important that the management look at the bigger picture and not just individual divisions. An intermediary can create an internal conflict of interest management committee which deals with identifying and addressing conflicts of interest. The committee formed by the market intermediary can establish a conflict management process which is followed through the internal control mechanisms. What is observed in the market is that financial companies such as internationally active financial groups that are large in size or engage in a wide range of financial activities tend to have in place effective mechanisms to manage conflicts of interest. However, this is often not the case for many smaller companies due to costs and other practical difficulties.

C.5 Regulatory Surveillance/Examinations

A high percentage of jurisdictions surveyed use regulatory surveillance to assess if firms are compliant with the regulatory framework in place to counter conflicts of interests. Regulatory surveillance of firms through on site and off site inspections is a regular feature in almost all jurisdictions. Regulatory surveillance can be used to check the internal controls for dealing with conflicts that market intermediaries have in place and to ensure that intermediaries are following the rules and regulations laid down in the laws or guidelines relating to conflicts of interest. Examinations for market intermediaries on conflict of interest can encompass the following areas: assessing the adequacy, effectiveness, and sufficiency of policies, procedures and controls in minimizing conflicts; reviewing to identify, analyze and weigh the effectiveness of internal conflict of management systems, Chinese Wall policies and procedures; and recommending procedures to further increase and strengthen an intermediaries internal conflict of management mechanism. Surveillance could also be used to detect and address cases where insider trading may take place. Furthermore, the regulator can also get involved in surveillance or examination of an intermediary upon the request of a client who feels that an intermediary might be exposed to a conflict of interest during its conduct.

C.6 Caveat Emptor

Caveat Emptor is a Latin phrase for "let the buyer beware" and is a strategy adopted for consumer or investor protection. A few regulators in the jurisdictions surveyed use Caveat Emptor as a strategy to alleviate market intermediary's conflict of interest. In the case of a conflict of interest this suggests that investors or clients should be informed about the deal or transaction they are getting themselves in. It places importance on the investor or client to make sure that they avoid situations where a conflict of interest could take place while dealing with a market intermediary. Once the client has been informed of Caveat Emptor the client will be getting involved in any transaction at their own risk.

Chapter 4 Regulations for different types of conflicts of interest

Due to a market intermediary providing a wide range of services many different types of conflicts of interests exist amongst them. The wider the range of services provided by a single market intermediary the greater the possibility of conflicts of interest which can be exploited. Such behavior by a firm or individuals will obstruct the efficient allocation of resources to their most productive uses and benefit the intermediary as a whole or a business unit within the intermediary. However, acting in such a manner can also have a detrimental effect on the intermediary's reputation, giving rise to a trade off between both circumstances. Regulatory action should be taken where necessary to reduce a conflict, but it needs to be balanced against any reduction in the economies of scope created through providing a combination of financial services.

This section will underline particular situations/areas within the range of services provided by the market intermediary where conflicts of interest may arise, such as: conflicts between brokerage and dealing; conflicts between corporate finance services and other securities/business services; conflicts that arise between asset management services and other securities/business services, and the regulatory framework, available in EMC jurisdictions, to manage and mitigate these conflicts. Furthermore, this section will highlight the incentives for a market intermediary to act in a conflicted manner and assess the costs and impact it places on its clients.

A. Conflicts between Brokerage and Dealing:

Through providing brokerage services an intermediary is purchasing and selling securities in the secondary market for a clients account. Clients place orders with a broker and the broker tries to satisfy those orders by purchasing or selling securities. In return for the brokers service they are given a commission by the client for each transaction made. Dealing on the other hand involves purchasing and selling securities in the secondary market for the intermediaries own account (proprietary trading).

By undertaking both these services concurrently many situations arise where the intermediary can favor its own interests over the interests of its clients. Providing brokerage and dealing services can put the intermediary in a situation where it is in direct conflict with its clients. Circumstances can arise where the intermediary can make use of its dealing services after gaining some valuable information through its brokerage clients. An intermediary can also allocate profitable securities to its own account rather than the client's, where the availability of the security is limited at a certain price. Different areas where conflicts can arise when an intermediary is acting as a broker facilitating customer traders and also engaging in proprietary trading or dealing are set out below:

A.1 Churning

Churning takes place when a broker is involved in excessive trading in a clients account for the purpose of generating commissions. The conflict here arises between the broker's interest and the interest of the client. Brokers want to maximize their income through commissions received from excess trading, which may lead them to make unprofitable investments for their client. Most of the regulatory authorities have rules prohibiting churning - excessive trading for the purpose of generating commissions to the detriment of clients' interest. When irregularities are found, regulators investigate them and build a case for legal action by looking into the trading record, the nature of the trades, the person in control of the purchase and selling activities, and the frequency of trades made over a certain period of time.

All respondents, except Colombia, United Arab Emirates, and Sri Lanka stated that they have measures against churning. The regulatory measures include prohibiting order execution that is not in line with the investor's investment strategies and ensuring that transactions are fair and reasonable in the context of the investor's financial situation and investment objectives. Furthermore, activity letters and periodic confirmation of account objectives and strategy are often required in order to safeguard market intermediaries against churning. The regulators, in most cases, have the authority to issue administrative cease and desist from processing orders, and file the complaint for injunctive relief in court when churning is discovered. Additional legal actions such as suspension of license or registration, financial remedy or imprisonment can also be enforced.

In the Cayman Islands, the Securities Investment Business Regulations (Code of Conduct) require licensees to ensure that transactions are fair and reasonable to the client. More specifically, the Statement of Guidance on Client Understanding, Suitability, Dealing and Disclosure prohibits a license-holder from carrying out transactions with unnecessary frequency or in excessive size, or for a client for whom the license-holder has discretion over the account's investment scheme. In case of breach, the Securities Investment Business Law allows the authority to revoke a license, impose a condition on a licensee, apply to the court for remedies like disgorgement, restitution or injunction, or require the licensee to take any other necessary action.

Similarly, in Korea, Article 68 of the Enforcement Decree of the Financial Investment Services and Capital Markets Act forbids soliciting a non-professional investor too frequently without taking into consideration his investment objective, financial status, investment experience, etc. For noncompliance, administrative sanctions such as cancellation of a license (Article 420) or a monetary fine of no more than 50 million won (Article 449) can be levied.

The Dubai Financial Services Authority (DFSA) has also laid out detailed regulations regarding churning. Executing orders for a client in the market intermediary's own discretion or transacting with an excessive frequency is considered churning. Depending on the gravity of noncompliance, the broker may see its license terminated or restricted and/or be required to seek approval of the DFSA before any future action is taken.

A.2 Front Running

This is a problem that arises when an intermediary deals in brokerage services and is also involved in proprietary trading. The conflict exists when a broker is involved in dealing services through executing orders for the intermediary's account, while taking advantage of advanced knowledge of pending orders from its client. For example, a broker who gets information from a client to undertake an order can place the same order for the intermediary's dealing account before that of the clients. Regulators in most cases regard this as an unethical market behavior in which a broker is not acting in the client's best interest.

The majority of the respondents prohibit market intermediaries from trading for their own accounts based on the information obtained from clients' orders, and the intermediaries need to carry out adequate supervisory responsibilities such as record keeping, maintaining an information barrier between the proprietary trading desk and brokerage division, and disclosing any conflicts of interest to ensure that no one takes advantage of private, incoming order-flow information.

Many jurisdictions enforce an obligation of fair dealing on brokers and dealers, and in case of misconduct, disciplinary sanctions are imposed. The types of sanctions range from monetary penalty, disgorgement of profits, warnings, and suspension of business to cancellation of license in more severe cases. Some jurisdictions such as the British Virgin Islands and Chinese Taipei have measures which require an appointment of a qualified adviser on the issue and/or the removal of individuals liable for breach.

In Malaysia, Capital Markets & Services Act 2007, Guidelines on Market Conduct and Rules of Bursa Malaysia Securities Exchange all state that priority must be given to the client's orders, and both administrative and civil actions may be taken for noncompliance. In Pakistan, Securities and Exchange Ordinance 1969 (SEO) strictly prohibits insider trading, which encompasses front-running, by specifically defining insider and inside information, and the person found responsible for breach is liable to a fine, cancellation of registration, bar on services etc. depending on the nature of such defaulting persons occupation/ involvement. Regulations for Proprietary Trading and Code of Conduct for Brokers forming part of the Brokers and Agents Registration Rules also provide measures for curtailing front-running.

A.3 Unfair Practices in Analysis, Report Preparation and Distribution

This situation can involve an intermediary creating a false or misleading report about a company which its client holds a stake in. The broker can use this to persuade its client to buy or sell the concerned security and do the opposite while transacting in its own account. This would be equivalent to the broker taking money from the client and putting it into the intermediary's dealing account. To prevent such conflict, internal controls are necessary to ensure that analysts exercise independence and diligence in analyzing investments and disclose all matters that could influence independence or objectivity of the report. Many jurisdictions require the full and complete disclosure in analysis reports of actual and potential conflicts of interest faced by the individual analyst, establishment of information barriers between research and investment banking divisions, and internal restrictions on analysts owning shares in companies they cover.

Unlike other jurisdictions which regulate unfair practices in analysis report preparation and distribution with laws and government rules, Panama uses the intermediary's internal control to ensure analysts' independence and objectivity. Most of other jurisdictions currently apply regulations against market manipulation or insider trade to analysts as well. In some jurisdictions like the Dubai International Financial Centre (DIFC) and Jordan, investors can claim against analysts to recover damages caused by analyst misconduct.

In Conduct of Business (COB) 6.3, DIFC has laid out detailed legislation regarding unfair investment research practices. It calls for sufficient internal control procedures to monitor and manage such analyst conflicts of interest. Examples of internal control mechanism include Chinese walls, analyst remuneration structure and trading restrictions, and conflict disclosures.

Pakistan requires analysts to have reasonable justification in their research recommendations, disclose any conflicts of interest that can harm the objectivity of the report, and retain all records used to support their views. In case of misconduct, the regulatory authority can cancel or suspend a registration, and the related person may be imprisoned or fined under the SEO.

A.4 Conflicts between Clients in Order Aggregation and Allocation of Securities

Order aggregation of client accounts or client accounts with proprietary accounts often results in conflicts of interest as it can benefit a certain client or the intermediary itself at the expense of other clients. Brokers may be inclined to combine orders for administrative convenience and to achieve lower execution costs typically associated with larger orders. Unless it is consistent with the duty to seek best execution for its clients, aggregation in general is forbidden.

Since brokers could defraud clients by allocating trades inequitably among clients, they are often required, before entering an aggregated order, to produce a written statement specifying the accounts to be aggregated and how it intends to allocate the order among those clients. Allocation must be made fairly between a client and the other parties whose interests have been aggregated by taking into account all factors including the sequence in which the orders were received, any relevant instructions received from the client, the relative sizes of the orders, and the current liquidity of the market.

Order aggregation is prohibited, if not constrained to certain conditions, in most surveyed jurisdictions. In the Dubai International Financial Centre (Dubai), COB stipulates that aggregation of orders is allowed under certain conditions. A broker can aggregate orders when the aggregation will not disadvantage any client, the basis and effect of aggregation are disclosed to the clients, and it has written standards and policies of aggregation. Allocation must be made fairly and equitably and the details of allocation must be kept in record.

The Capital Market Law and Executive Regulation in Oman states that the priority for execution should follow the order of price, time, and type of order. It also requires market intermediaries to establish the internal control system to ensure fair placement, execution, and allocation of orders.

Pakistan, on the other hand, forbids brokers from engaging in any aggregation of a client's order with other clients' orders or with own account orders. Non-compliance could be subject to a monetary penalty or a suspension of "membership which leads to suspension of license/registration.

B. Conflicts of Interest That May Arise Between Corporate Finance Services and Other Securities/Business Services

Corporate finance services are the services related to the capital structure of a company. This could include underwriting IPO securities in the primary market, business of arranging for and intermediating the mergers and acquisitions of companies, or acting as an agent for that purpose, business of providing advisory services on the merger and acquisition of companies, or business of managing properties of a private equity company. The range of permissible services may vary from jurisdiction to jurisdiction depending on their legal frameworks.

Corporate finance is part of the services provided by investment banks. Investment banks gain economies of scale and scope, through provision of financial services which tackle information asymmetries in the capital market. Investment banks have recently been at the centre of criticism due to an apparent lack of independence in their behavior and policies with regards to the objectiveness and independence of their research reports and analyst recommendations. Conflicts of interest are a consequence of the function of investment banks which intermediate the interaction between issuers and investors in the capital market. Issuers will benefit from overly optimistic research while investors on the other hand will benefit from unbiased research. If the incentives at the intermediary for the provision of these two services are not properly aligned, employees at one side of the firm will be tempted to distort information to the advantage of their clients and the profit of their own department or business unit within the intermediary[11].

The previous report published by IOSCO[12] covered in detail the types of conflicts of interest that arise in securities offerings and how market intermediaries manage those conflicts. This report further broadens the scope by addressing the typical types of business conducts which can cause conflicts of interest as market intermediaries carry out both corporate finance services – e.g. securities offering and M&A - and other securities businesses.

The main conflicts faced while providing corporate finance services are examined below:

B.1. Pricing (Underpricing/Overpricing)

The problem of pricing a security can arise during a securities offering. As the intermediary is dealing with both sides of the market - the issuer and the investor, it may favor one side over the other in terms of setting a price at which the security would be made available. The issuer would want the best possible price for the security while an investor would want to purchase the security at a price favorable to him. This could provide an intermediary with incentives to underprice or overprice the security.

Securities could be underpriced by a market intermediary due to a high demand existing for the securities at offer. The intermediary might believe that a lower share price would lead to a higher value of shares sold. This could be beneficial to the reputation of the intermediary as well as increase the net fee it receives. The market intermediary could have strong ties with an institutional investor and underprice a security in order to benefit the investor. Furthermore, a security could be underpriced if the proprietary trading desk at the intermediary is interested in purchasing the security at offer. The conflict created through underpricing will be greater where the fee the intermediary charges is related to a successful issue.

In the same way an intermediary could have an incentive to overprice securities. If the intermediary through its proprietary trading desk or in any other form has a position in the security at offer, it may look to charge a higher price. In the case where the issuer is a debtor to the intermediary, it might look to set a higher price in order to retrieve the maximum amount for the issuer, in order to pay back its debt to the intermediary.

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11 “Investment Banks, Scope and Unavoidable Conflicts of Interest” Eric Sirri, Federal Reserve Bank of Atlanta, Economic Review, Fourth Quarter 2004.

12 See note 7.

When overpricing or underpricing happens, the market intermediaries involved are required to file a disclosure report outlining the reasons and effects to prevent such conflict of interest. Preferably, the intermediary's proprietary trading desks, sales teams, research analysts, brokerage clients and affiliated owners should not be involved in the pricing process as their interests are not aligned with that of the issuer.

According to the survey, while six jurisdictions did not regulate pricing, Chinese Taipei requires a full disclosure of the method, principle, and calculation used to derive the price when underwriting securities. It also stipulates situations where further explanation for price difference is required. Likewise, in Turkey, if the initial public offering (IPO) price of a security is different from the listed or nominal price, an evaluation report should be prepared and disclosed.

In Thailand, the pricing method is not regulated but certain parties, who could have influence over pricing, are restricted from being allocated shares.

B.2. Preferential Allocation of Securities to More Profitable Clients

An opportunity for a conflict of interest arises during an oversubscribed issue where an intermediary has a say in the allocation of securities. This could cause a market intermediary to prefer certain clients over others based on personal ties or the promise of future business. For instance, preferential allocation can be made to a more favored trading client, perhaps a large and high commission-paying hedge fund as a sign of appreciation for the business it has provided or in return for a potential trading commission. To resolve this issue, fair and reasonable allocation criteria and methods must be put in place before any allocation is made. Disclosure of actual allocations will ensure that an issuer is informed about the allocation decisions made on its behalf by the intermediary.

Amongst the 11 jurisdictions which regulate allocation, discrepancies in the details of regulation still exists. In Thailand, allocations must be made fairly with one exception. The Securities and Exchange Commission of Thailand allows trade volume to be used as a criterion of allocation. In addition, a market intermediary must submit an allocation report outlining the criteria of allocation, the persons allocated, and the proportions of securities allocated, to the Commission within 45 days of the end of the allocation period. Some jurisdictions, like Turkey and Malaysia, have more general provisions enforcing intermediaries to allocate securities fairly and equally among clients.

In Chinese Taipei, it is forbidden that securities are allocated to parties related to the issuer or the underwriter who have material interest in the securities. In Korea, regulations also prohibit discrimination against certain subscribers in securities allocation with no legitimate reasons. Violation of the regulations may result in cancellation of license, imprisonment or a fine.

B.3. Advising Multiple Bidders in a Transaction

An intermediary could find itself faced with a conflict of interest where it is representing the interests of two or more bidders in a security offering. As mentioned above allocation of securities could be an area of conflict. The intermediary, due to its preferences could provide misleading advice to one of the clients in order to benefit another client. Advising multiple bidders can bring more commission revenue to the firm. However, an investment advisor must act solely in the best interest of the client, even if that interest is in conflict with the advisor's financial interest. If such a situation arises, investment advisors must disclose any conflict or potential conflict to their clients.

Around a third of the jurisdictions surveyed regulated this issue while in one jurisdiction such practices are allowed. To avoid the conflict of interest arising from advising multiple bidders in the same transaction, in Chinese Taipei, the lead manager is required to publish a book building or a competitive auction announcement in the newspapers with detailed information about the bid. In Colombia, this is also considered as a type of conflict of interest subject to a fine, suspension or cancellation of a license.

It is interesting to note that in Montenegro, market intermediaries are allowed to advise multiple bidders in the same transaction. Similarly, in 7 other jurisdictions such as Bermuda, Nigeria and Oman, no regulation against advising multiple bidders is indicated.

Even among the jurisdictions which do not entirely prohibit advising multiple bidders, such as Dubai, Korea and many others, the market intermediaries are required to have adequate internal control systems to identify, prevent and manage conflicts of interest between clients.

B.4. Advising the Seller and a Potential Buyer in the Same Transaction

A conflict of interest is inevitable when a financial advisor who is supposed to act in the best interests of his/her client advises both a buyer and a seller in the same corporate finance transaction like an M&A deal. Their interests directly clash since the buyer desires the lowest possible price whereas the seller wants the highest possible price. Under such circumstances, an investment advisor owes professional duties to both sides in a transaction, which may create disputes and put the advisor's integrity and reputation at risk. Due to the opposing interests of the seller and a potential buyer, an advisor can represent and promote one side only at the cost of the other. The best way to avoid this is to refrain from acting on behalf of both the buyer and the seller. If this is not possible, informed consent is suggested to be obtained from the client and proper information barriers should be put in place.

A third of the countries surveyed regulated this issue while one jurisdiction allows such practices to take place. In both Korea and Chinese Taipei, the market intermediary is required to inform the client about the conflicting roles it is going to play in the transaction. In 6 other jurisdictions, including Thailand and Dubai, there are relatively broad provisions in place to regulate dual advising instead of specific rules against it. In Montenegro, the market intermediary is allowed to engage in such practices, while 7 other jurisdictions reported no specific regulations governing dual advising exist.

B.5. Exaggerated Investment Solicitation or Sales of Securities Underwritten by the Intermediary

During the process of underwriting a securities offering, an intermediary has an incentive to make misleading statements in order to sell the security. Since the compensation for a corporate finance transaction is often based on the successful completion of a deal, the market intermediary may have the incentive to distribute the underwritten securities with overly optimistic reports or an exaggerated sales pitch. It appears that the optimistic reports are designed more to promote the issuer's interests rather than to fulfil the needs of the investor. If the solicitation is biased or fraudulent, investors will earn lower than expected returns or could even lose a significant portion of their investments.

An effective underwriting would benefit the intermediary's reputation and would help in bringing business in the future. The problem arises when the underwriting is done on a firm commitment basis i.e. an underwriting where an investment bank commits to buy and sell an entire issue and assumes all financial responsibility for any unsold shares[13]. This may influence the intermediary to provide advice that is not in the best interest of the investors, due to its own interest in a successful underwriting. Such a conflict can also arise where the underwriting is done on a best efforts basis[14].

More than half of the jurisdictions surveyed regulate this conflict using government rules and laws. Mostly jurisdictions use general disciplinary actions to deal with non-compliance. In one case imprisonment is also used. Exaggerated sales pitch such as profit guarantee is prohibited in Montenegro. In Pakistan, quoting an expert in the prospectus to invite subscription needs to be done with care. The Companies Ordinance 1984 stipulates that a market intermediary must ensure the expert is independent from the company and prior consent must be obtained from the expert where the issue of a prospectus contains a statement by him. Thailand also has a detailed provision allowing only the information from the prospectus to be given to clients.

In Malaysia, the *Capital Markets & Services Act 2007* (CMSA) strictly forbids any false or misleading information that could induce a client into investing in the underwritten securities. Additionally a person who underwrites a security cannot solicit or recommend the same security unless this fact is disclosed in advance. Similarly, in Chinese Taipei, Stock Exchange Corporation rules and OTC rules stipulate that investment solicitations should be made independently and must not harm the interests of the clients.

B.6. Publishing Favorable Analysis Reports

There is inherent potential of conflict of interest when an analyst for a brokerage firm covers the stock of a company while the corporate finance division of the same firm underwrites securities of the same company. Thus, a situation arises which makes it difficult for the analyst to preserve his independence and objectivity. Investment banking services have been under scrutiny due to the objectiveness and independence of their research or analysis reports. The research team or analyst is given the task of analyzing stocks or securities and forming recommendations of buy or sell based on its analysis. A market intermediary could publish a favorable analysis report in a case where the client is a debtor of the intermediary. The intermediary will expect that a favorable report would lead to a stronger underwriting in case of an offering and the proceeds would be used to pay back the intermediary.

Corporate executives look at the overall performance of the investment bank and especially review how favorably it has been writing about the company in its research reports, when selecting an underwriter, and tend to expect an optimistic recommendation report from the underwriter they chose. This may create a situation where market intermediaries could be

[13] See Note 7;

[14] Underwriting on a Best Efforts basis would involve the underwriter doing its best to oversee but not guaranteeing the sale of a security in the primary market.

tempted to promise issuers favorable research recommendation in return for a future business opportunity. There could also be outside pressures by the issuer or major shareholders on an analyst to make a favorable recommendation through various means such as refusing to provide key information to the analyst unless he appears willing to publish a positive opinion of the company. Favorable analysis reports could also be created in order to raise the price of a security, in a situation where the intermediary itself has a shareholding in the concerned security.

While a favorable research report could benefit the issuer by bringing more investment and ensuring a successful completion of a deal, it can harm the investors by misleading them into a not-so-profitable investment. In other words, there is a great chance that a market intermediary would have financial or other incentives to favor the interest of the issuer at the expense of the investors' by writing a biased report.

Many jurisdictions, as a result, require market intermediaries to establish and maintain adequate procedures to protect research analysts from conflicts of interest, and supervise the work of analysts, the content of their reports, and the reasonableness of their ratings. They also demand physical separation of research and corporate finance division and prohibit research analysts from participating in solicitation of corporate finance service. Furthermore, research analysts' compensation should not be linked directly or indirectly to revenues from corporate finance service or performance evaluation by personnel in the corporate finance division.

Regulations in Chinese Taipei and Bermuda state that any relationship that could impair the objectivity and independence of research reports must be disclosed. In Thailand, the market intermediary is banned from publishing analysis reports for an issuer 15 days before the issuing date until the closing date. If a report is to be published on other dates between the filing date and 30 days after the closing date, it must be based only on the information in the prospectus, prepared independently by the research unit, accompanied by conflicts of interest disclosure, prepared professionally and fairly, and submitted to the SEC the next day after it is published.

B.7. Using Non Public Insider Information Obtained in the Process of Underwriting Securities

During its dealings with clients in the process of underwriting securities, an intermediary gets its hands on non public insider information relating to the firm. This can turn out to be a severe conflict due to an intermediary's business structure and its dealings with multiple clients concurrently. Insider information will provide the intermediary with information about the true value of the security and a better understanding of the general financial health of the company. The intermediary can use this information to either buy or sell securities on its own account or provide the information to the benefit of preferential clients.

Exploiting material, non-public information of the issuer and profiting based on the privileged information is a clear breach of fiduciary duty owed to the corporate finance client. Maintaining client confidentiality is crucial to market intermediaries providing corporate finance services, especially to the large multi-service providers. Clients must be able to have the confidence that information about themselves will not be exploited for the benefit of other clients with different interests or other divisions within the intermediary.

Hence, Chinese walls are required to restrict the flow of information between different departments, and prevent leakage of sensitive corporate inside information, which could influence the advice given to other investors and allow the insiders to take advantage of facts that are not yet disclosed to the general public. The use of inside information is generally perceived to be the biggest evil amongst the different conflicts and severe legal action has been taken against many individuals in different countries.

Other than the jurisdictions which did not provide answers, almost all respondents heavily regulate insider trading and stated that they have measures against it. Most jurisdictions consider it is illegal for anyone with inside information to buy or sell stocks based on their special knowledge or transmitting such information as it could cause financial damage to the issuer and undermine market integrity.

In Bermuda, General Business Conduct and Practice Code of Conduct prohibits a market intermediary from knowingly trading on non-public information and also from transmitting any material non-public information to others to allow them to benefit from such information. Likewise, in Thailand, market intermediaries shall not take advantage of non-public inside information obtained in the process of underwriting securities, and must have Chinese walls between the underwriting unit and other units. Oman's Executive Regulation states that insiders should not exploit undisclosed material information when dealing in the securities of the issuer especially during the period while it is disclosed to the public. In Oman and Turkey, imprisonment or a monetary penalty is imposed on violators. In Montenegro, the regulation defines insiders in greater depth and prohibits them from acting on any unpublished information that could benefit certain participants in a trade.

C. Conflicts of Interests That May Arise Between Asset Management Services and Other Securities Businesses/Services

Asset management services deal with operating funds raised from more than one investor without any control by those investors over the investment decisions and distributing benefits of the investment. Asset management services in this report will include CIS distribution. CIS are a vehicle for pooling the investments of individuals in order to obtain professional management of the investors' pooled assets. Investors put their trust in the operator of the CIS to act in their best interests and reward the operator through loyalty and payment of fees[15].

As an intermediary providing asset management services can reserve judgment on how to operate funds from its investors, many situations creating a conflict of interest can take place. The separation of ownership and management of the fund is what brings about the conflict. The conflict essentially exists between those who invest in the funds and those who organize and operate them. In the case of a market intermediary, provision of asset management services can conflict with other responsibilities of the intermediary due to its various functions. Due to an increasing use of asset management services by both institutional and individual investors, the proper regulation of these services is critical in achieving the objectives of securities regulation as mentioned by IOSCO[16]. The different ways in which such conflicts can occur are mentioned below:

[15] *Conflicts of Interest of CIS Operators*, Report of the Technical Committee May 2000 see note 6;

[16] *Objectives and Principles of Securities Regulation* June, 2010, see note 4.

C.1. CIS Operation and Proprietary Trading

An intermediary organizing a CIS could use the CIS's assets for its own gain and thus to the detriment of the CIS investors. The provision of several services by the intermediary will pose a problem since the ownership of the fund lies with the investors but the decision making power is left to the CIS operator. The proprietary trading function of an intermediary would directly be competing with its CIS operation to invest in profitable securities, creating circumstances which may lead to conflicting interests for a market intermediary. There are many different ways in which this could occur.

The intermediary could use the information gained through its CIS operation to benefit its proprietary trading. Where intermediaries engage in proprietary trading they may front run orders based on price sensitive information to their own accounts. The intermediary can place profitable investments in its own account and place unprofitable investments which it has to allocate in order to fulfil its other obligations into the CIS. While operating a CIS an intermediary invests in a security and hence could allocate trades with favorable prices into its own account and trades with unfavorable prices into the CIS. In this way, intermediaries operating a CIS could rid themselves of unattractive securities by dumping them into the CIS.

Conflicts of interest can occur where a CIS does not inform its investors about how ownership rights attached to their assets will be used. In such a case the CIS can use its ownership and control rights, particularly voting rights that it may have in companies in which the CIS invests to benefit its proprietary trading account. A conflict creating situation can also arise where the board of directors of the CIS operated by the intermediary is not independent, and thus investment decisions are made for the intermediary's benefit rather than the investors. Where a CIS operator has discretion when appointing directors, custodians and depositories, they may have the incentive to select persons who are likely to make favorable decisions to the CIS operator rather than act in the best interest of the CIS and CIS investors.

As a measure to safeguard the investors, Malaysia has a regulation that stipulates a CIS operator must act in the best interest of the client and when there is a conflict between the clients' interests and the asset management's own interest, clients' interests must be given priority. And the operator should not take advantage of the client information for its own benefit and the fund's property should be held separately from the property of the CIS operator. Along the same line, in Korea, a CIS operator is forbidden from pursuing its own interest at the expense of the interest of the CIS the operator manages.

In Romania, the market intermediaries are required to establish sound administrative and accounting procedures to deal with CIS transactions and to arrange adequate internal control systems to minimize the risk of conflicts of interest between the investors and CIS or between CIS themselves.

SEC guidelines in Thailand more specifically state that CIS operators must ensure appropriate control mechanisms are put in place in order to prevent conflict of interests between the CIS and the operator's proprietary unit. Inter-account transactions are allowed only when they are necessary and beneficial to the CIS, and are in accordance with the fund's objectives.

C.2. CIS operation/Sales of CIS Interests Vs Brokerage

Since an intermediary purchases and sells securities for its brokerage clients and also makes investments as part of its CIS operation, there exists the possibility of a conflict of interest arising when both duties are undertaken simultaneously. On the other hand the sales of CIS interests can give rise to another potential conflict of interest for an intermediary undertaking brokerage services. In such a case the intermediary could have an incentive to satisfy its brokerage clients by allocating the sales of CIS interests to their account.

By nature, the market intermediary operating CIS funds generally takes the liberty of deciding whom it directs CIS portfolio trades to. Due to its discretion, the intermediary may be tempted to direct its CIS portfolio trades to its brokerage unit or brokerage affiliate without making efforts to seek best price and execution. In such case, the interest of CIS clients will be sacrificed for the benefit of its brokerage unit or brokerage affiliate. Due to the intermediary having the final say to whom to allot assets to, it may also favor certain brokerage clients over others when dealing with the sale of CIS interests. This could also be a cause of concern when a new client is given preferential benefits over existing ones.

In a competitive industry an intermediary might offer benefits such as first allocation of an in demand security or a lower commission charge in order to try and induce a potential client. As existing clients will be unaware of this treatment, it could pose a potential conflict of interest. While dealing in CIS, an intermediary is made available with information from many different investors. This information could be provided by the intermediary to the benefit of its premier brokerage clients and hence to the detriment of the CIS investors.

The conflict of interest created between an intermediary's CIS operation and brokerage unit is regulated by half of the Jurisdictions. In order to avoid the conflict, regulations in Korea prohibit CIS operators from providing direct or indirect benefit to a broker/dealer who sells CIS securities against investors' interests. In Thailand, CIS operators are also required to establish guidelines and measures to prevent leakage of information obtained from the CIS operation to brokers.

In Bermuda, market intermediaries can only direct CIS fund trades to affiliated brokers with a disclosure of such relationship to the investors. Any material non public information of the CIS operation that could be exploited should not be communicated to brokers.

In Pakistan, CIS operation cannot be performed concurrently with brokerage services, and only sale and distribution of CIS units are allowed. Sri Lanka is not exposed to conflict of interests between CIS operation and other financial services as they do not allow CIS operators to act as market intermediaries.

C.3. CIS operation Vs Corporate Finance Services

An intermediary taking part in CIS operation alongside corporate finance services would be undertaking activity for both sides of the market which can create a potential conflict of interest. During a securities offering an intermediary would be representing the issuer through its corporate finance services and the investor through its CIS operation. This can cause an intermediary to make decisions involving pricing or allocation for its own benefit or according to its preferences.

CIS funds under management of the intermediary or its affiliates may be given preferential allocation of IPO securities. Taking such measures to benefit the CIS investors would not be in the best interest of the issuer of securities hence the conflict of interest. On the contrary the intermediary in some cases may also have an incentive to work in the interest of the issuer of securities, thus to the detriment of the CIS fund.

If a security underwritten by the intermediary is undersubscribed, it can allocate the securities to the CIS funds. The undersubscribed security may be valued at a very high price which would adversely impact the CIS fund. Since the investors have no control over the management of the funds such a decision by the intermediary could be against the objective of the fund. Such a situation is more likely to occur when the intermediary is underwriting the security on a firm commitment basis.

Although the conflict of interest between CIS and corporate finance services is a serious one, not many jurisdictions seem to have specific guidelines against the conflict of interests arising between the CIS operation and corporate finance services. As this type of conflict could be found in jurisdictions where the financial market is sufficiently developed to generate financial business activities in corporate finance business as well as where the market intermediary is allowed to perform both financial services concurrently.

Among the six countries which do have regulations in place, Malaysia requires CIS managers to allocate securities fairly among clients and all transactions must be conducted at an arm's length. In Chinese Taipei, CIS operators providing discretionary investment services are allowed to invest in corporate finance transactions underwritten by an affiliate only when related conflict of interests are disclosed to the clients and written consent is obtained. In Thailand, purchasing unsubscribed securities underwritten by the intermediary itself or an affiliate without appropriate justification is regarded as breach of fiduciary duty to the clients.

D. Regulations for Other Conflicts of Interest in EMC Member Jurisdictions

South Africa: Rebate arrangements between intermediary and CIS operator where client is not getting benefit of rebate. All rebates must be disclosed upfront and if not possible to give the monetary value, the value must be given later.

Malaysia: Even though there are provisions regarding the appointment of a related party as trustee to a fund, Securities Commission of Malaysia has not approved such appointment as it may create possible conflicts of interests. A management company of a fund shall not delegate investment management function to an external fund manager who is a related party to the trustee of the said fund.

Chapter 5 Regulatory Challenges and Practical Considerations

The jurisdictions surveyed for this report highlighted the need for more regulatory attention for certain types of conflicts of interest. The more significant types of conflicts of interest faced by jurisdictions include:

- Using non public insider information obtained in the course of the business;
- Front-running;
- Churning;
- Cherry picking[17];
- Unfair treatment among investors; and
- Unfair practice in analysis report preparation and distribution.

The regulatory challenges recognized by the securities regulators differ from jurisdiction to jurisdiction depending on each jurisdiction's market situation. However, as the results of the survey reflect, conflicts of interests connected to corporate finance services are recognized or regulated in fewer jurisdictions than conflicts of interests related to other financial services such as brokerage and dealing. The jurisdictions face the challenge to establish an appropriate internal controls procedure that effectively manages the conflict of interests in these scenarios.

Most of the responding jurisdictions understand the importance of regulating conflicts of interest and have legislative proposals or regulatory considerations under way to improve current regulations on conflicts of interest in order to prevent conflicts from occurring due to the business conduct of market intermediaries. In Pakistan, there are various on-going actions to improve the market system and regulatory framework as well as to amend laws in order to enhance the investor protection system and prevent potential conflicts of interests involving market intermediaries.

While most regulatory authorities have been paying attention to the above types of conflicts of interests, in some jurisdictions such as the Cayman Islands and Panama, there have been no sanctions imposed to date. In case of noncompliance, the related market intermediary is subject to a monetary fine in most of the responding jurisdictions.

A. Guidelines and Appropriate Regulatory Structure for Management of Conflicts of Interest

One of the objectives of any financial regulatory body or supervisory agency is to eliminate financial crime and maintain efficient, orderly and clean financial markets. There is a growing concern over the risks generated by financial institutions exploiting the information they legitimately receive for illegitimate purposes. Such actions can cause serious damage to market confidence. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interest of clients and ensure proper management of conflict of interest and to maintain fair, orderly and efficient financial markets.

[17] *Cherry picking* means the act of selecting profitable assets for the intermediary's own account and placing unprofitable assets in clients' accounts in the course of asset management.

Greater alignment in regulatory scope and rules and the consequential development of rules and procedures across all jurisdictions would lead to more efficient management of conflicts of interest and reduce cost for both market intermediaries and customers. The government in Australia decided to impose an obligation on the entire financial services industry to have adequate arrangements for managing conflicts of interest rather than just focusing on particular issues or a specific sector[18]. This was done in order to bring uniformity of regulation in financial services as far as is practicable. However, the increasingly global nature of modern capital markets means that, even if implementation of international regulatory principles and standards were universal, the benefits of these principles and standards could be defeated if financial regulators and law enforcement agencies lack the ability to take effective enforcement action, to share enforcement-related information, and coordinate investigations. In this context it is essential to develop a framework for facilitating regulators in different jurisdictions to better manage conflicts of interest. It is also important that regulations and rules are created which have an impact in changing the behavior adopted by firms'. As conflicts of interest may arise in a number of forms as the survey findings indicate and the degree of sophistication of capital market differs across jurisdictions, it is practically inevitable for securities regulators to set up high-level rules and for market intermediaries to be encouraged to use their best judgment to avoid or mitigate conflicts of interest. The following are suggested guidelines for effective regulation, monitoring and resolution of conflicts of interest of market intermediaries that would help guide securities regulators when they develop their own legal and regulatory framework:

- **Active involvement of senior management of market intermediaries:**

  The process for identifying and mitigating conflicts of interest should be developed in an appropriate manner. Senior management of the intermediary should be engaged fully in all aspects of conflicts identification and take a broad view of the risks posed to their business. The responsibility for conflicts identification and management should be clearly allocated to specific individuals and controls to mitigate conflicts need to be reviewed on a regular basis[19]. For this purpose a formal conflicts policy needs to be put in place;

- **Clear and concise policy to be adopted:**

  The conflicts of interest policy must identify conflicts arising due to provision of different services by an intermediary and specify procedures to deal with each particular case. The policy should be able to highlight conflicts of interest according to the business structure and activities of the market intermediary;

  Clearly stated policy and procedures assist in limiting unnecessary use of discretion and communicate to all concerned i.e., internal employees, customers, regulators, etc. the intent and procedures of the intermediary.

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18 ASIC *Managing Conflicts of Interest in the Australian Financial Services Industry*, May 2006.

19 *Dear CEO Letter – Conflicts of Interest*, Financial Services Authority November 2005, available at http://www.fsa.gov.uk/pubs/ceo/conflicts_18nov05.pdf.

- **Adequate disclosure to be made:**

Disclosure of an actual or potential conflict should be made to a customer to the extent that it does not entail a situation where the confidential information of other customers cannot be protected as a result of such disclosure. In case where a firm is not reasonably confident that other procedures and measures in place for management of the conflict will prevent the risk of damage to the client's interests, disclosure should be mandatory. However, over reliance should not be placed on disclosure.

- **Information barriers:**

Information barriers need to be carefully set up between different departments or affiliated businesses during sensitive times balancing the effect of reduction of synergies of information collection, to that of economies of scope in information production. Departments in an intermediary which are prone to conflicts (such as research and investment banking departments) should be separated to prevent the flow of information between the two groups.

- **Effective procedures to be put in place:**

The intermediary should pay special attention to the activities of investment research and advice, proprietary trading, asset management, portfolio management and corporate finance business, including underwriting or selling in an offering of securities and advising on mergers and acquisitions. In particular, such special attention is appropriate where the firm or a person directly or indirectly linked to the firm performs a combination of two or more of those activities.

Jurisdictions should ensure that the procedures and measures are in place requiring relevant persons engaged in different business activities involving a conflict of interest, carry on those activities at a level of independence appropriate to the size and activities of the firm and the group to which they belong.

Effective procedures should be in place to prevent or control the exchange of information between relevant persons engaged in activities involving a risk of a conflict of interest, where the exchange of that information may harm the interests of one or more clients.

- **Remuneration to commensurate the activities**

There needs to exist a separation of a link between the remuneration of relevant persons engaged in one activity and the remuneration of or revenues generated by different relevant persons engaged in another activity where a conflict of interest may arise in connection to those activities[20].

[20] The EU Commission Directive 10 Aug, 2006. Implementing Directive to EU "Markets in Financial Instruments Directive (MiFID), April 2004"

- **Maintaining record of activities**

Intermediaries should be required to keep and regularly update a record of all the different kinds of activities it has carried out which has given rise to a conflict of interest. This would help the intermediary in identifying situations which give rise to conflicts in order to prevent them from occurring in the future.

- **Specific prohibitions and stringent penalties**

Regulators need to encourage market intermediaries to adopt internal control mechanism to effectively address conflicts of interest. Where possible, the regulatory framework should cover these requirements along with clearly defined penalties and punishments for non compliance thereof. Intermediaries that are exploiting conflicts of interest need to be severely reprimanded.

Chapter 6 Conclusions

Conflicts of interest cannot be accepted as an unavoidable fact of life, even though the existence of conflicts is inherent in the business model of most firms. Conflicts of interest faced by market intermediaries have become a significant problem for the financial industry as a whole and it is essential for regulators to tackle this issue. Recent scandals in the financial industry worldwide have put doubts over markets ability to adequately control conflict of interests. Regulators have come under fire for not having sufficient and appropriate regulations in place to counter the risks posed by conflicts of interest. New regulations for management of conflicts of interest are required to prevent any further loss of investor's confidence in the financial system.

In evaluating remedies it is important to consider that the market intermediaries providing information to financial markets have access to a lot of information. Policies should be designed so that remedies increase the effectiveness of these agents rather than constrain them. Market discipline in the form of penalties and litigation that is focused towards limiting conflicts is important. A lack of information makes it difficult to punish firms exploiting conflicts of interest. The suggested guidelines can be used to address this problem however the applicability of the guidelines will vary from jurisdiction to jurisdiction.

The EMC has identified and attempted to draw out some guidelines for the management of conflicts of interest facing market intermediaries that can be considered by the jurisdictions contemplating to implement or create regulations for conflict of interest management. The EMC would however like to stipulate that in implementing these guidelines, there is no standard or prescriptive set of rules that can apply across the board.

This Report does not purport to recommend tools and methods as necessary or appropriate for all jurisdictions. Whether a given method is beneficial for a specific jurisdiction can only be determined by the respective regulator keeping in view its approach to supervision and taking into account the market practices, business structure of intermediary's and legal requirements of that jurisdiction. Individual regulators would have to tailor their systems to fit the circumstances of their own markets.

Moving forward regulators need to realize that new regulations should be focused towards changing the behavior of intermediaries, as it is the only solution to try and eliminate conflicts of interest. Several regulators have implemented certain guidelines or are in the process of strengthening their regulatory framework to better tackle the risks posed by market intermediaries' conflict of interests. Mechanisms should be put in place between different jurisdictions to develop cooperation between regulators to share experiences and information relating to better management of conflicts of interest facing market intermediaries. Such interaction will also enhance bilateral cooperation and initiatives between member jurisdictions.

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