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Conflicts of Interest, especially in Asset Management

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Abstract

Until 15 or 20 years ago, asset management was largely the task of an (often large) department of a bank that dealt with securities. It was fully integrated in the overall banking business and asset managers were usually acquainted with the transactions the bank was engaged in; in the securities field, public issues, private placements, underwriting and M&A work was often done in the same department and was familiar to most of its members. Institutional and individual portfolios were managed together. The same situation existed with regard to the bank's other functions, such as its loans business or its position in the payment systems. Asset managers could obtain information about the financial standing of the firms the bank was lending to, and on that basis make their investment decisions. This raised the question of whether the bank should protect its asset management clients by selling the shares about which it had unfavourable information: did the bank not have an overriding fiduciary duty to those clients?

Conflicts of interest, especially in asset management

Eddy Wymeersch*

1. Conflicts of interest are inevitable in financial services.

Up to 15 to 20 years ago, asset management was largely the task of a sometimes larger department of the bank dealing with securities. It was fully integrated in the overall banking business and usually asset managers were acquainted with the transactions the bank was engaged in: in the securities field, public issues, private placements, underwriting, M & A work was often dealt with in the same department and was familiar to most in that department. Both institutional and individual portfolios were managed together. Similar issues related to the other functions of the bank such as its credit activity, or its position in the payment systems: asset managers could obtain information about the financial standing of the firms the bank was lending to, and on the basis thereof make their investment decisions. The question was raised whether the bank should not protect its asset management clients by selling the shares about which it had unfavourable information: was there not an overriding fiduciary duty to that client?

To illustrate how much the existence of conflicting situations was part of the prevailing culture of that time, clients sometimes valued that asset managers had better information about the bank's transactions and would take advantage of their privileged information. Even today, some asset managers still indicate to their clients that they could have them benefit from their higher quality of information about the securities to be acquired for the portfolios managed, and this on the basis of the bank's broad presence in the markets. Conflicts of interest abound.

A related question is that of banks' or asset managers' directors being appointed board members of listed companies: although not strictly forbidden[1] it may create delicate situations, in which both the director and the asset manager would be conflicted and both would normally be bound to abstain. So e.g. will a bank will be expected to abstain from rendering certain services to the listed company, such as delivering a "fairness opinion" relating to the shares of that company, if one of the bank managers sits on the board of that company.

In the late eighties, the question about how to deal with conflicts of interests was increasingly raised: under US and UK influence, a new terminology was invented such as "Chinese walls" and fiduciary duties, notions not very familiar to the continental European professionals. The awareness about the impropriety of said conduct increased, resulting in voluntary guidelines, or more formal "conduct of business codes" avoiding information about sensitive banking business to be communicated to the asset management side. The insider trading directive of 1989 and the Investment Services directive of 1992, article 11, witness to these regulatory developments. New techniques for getting grips on conflicts where developed in connection with the fight against "insider trading": "trading windows", "restricted lists" belong to the widely used instrument to avoid this type of conflict.

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1 See the Belgian Banking Act of 22 March 1992, art 27, whereby the rules for bank directors to be appointed to boards of other companies has been made more flexible.

If considerable progress has been made to avoid or combat conflicts of interests in the provision of financials services, it also has become clear that not all conflicts can be avoided and there will always be residual cases where one will have to rely on the individual's sense of ethics.

2. Provisions in the EU directives dealing with conflicts of interest.

In the regulation of financial services, one will quite frequently come across rules that explicitly deal with conflicts of interest. A short analysis of the applicable rules follows: it is based on the EU directives, but in practice one would have to analyse national regulations as these often refer in more detail to conflict cases.

The EU financial services directives contain several provisions that directly address conflicts of interest while other provisions will also have an indirect bearing on the subject. Strikingly, few comparable provisions are found in the European company law harmonisation directives, except with respect to the activities of auditors[2].

In the Market Abuse field, one can identify the prohibitions applicable to primary insiders, at least in some way, as relating to a conflict of interest situation: company directors should not take advantage of insider information, on the one hand while this can be analysed as appropriating information from the company, on the other while this will undermine investor confidence, and harm the company's reputation[3].

More explicitly, the new rules applicable to financial analysts[4] and journalists pursue similar objectives. The preamble clearly states that disclosure of possible conflicts has to be made but no further measures are mandated[5]. The rules on financial analysts are most clearly inspired by the fear of biased opinions that may engage the liability of the analyst and the institution to which he belongs. The technique for dealing with the conflict is on the one hand general and on the other very traditional: the analyst report should mention to what extent the analyst may be conflicted[6]. There is no substantive prohibition for an analyst to publish reports that reflect too closely the interest of the firm he is working for, nor to hold securities. But organisational measures, such as separation of functions within an investment firm should be introduced[7].

The regime applicable to journalists is intrinsically equivalent[8]. However in order to avoid conflicts with constitutional provisions on the freedom of the press, the directive allows the regime applicable to journalists to be laid down not in state regulations, but in a self regulatory instrument, provided that it is appropriate and equivalent to the provisions of the directive. Hence journalists that would be conflicted e.g. due to their holding of securities on

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2 See the 8th directive, dated 10 April 1984, where one only finds a reference to the auditor's independence (art 24); comp. art 23 to 25 and 40 of the revised 8th company law directive, before renumbering of the articles; comp. Recommendation of the Commission on Auditor independence 2002/590/EC of 16 May 2002, OJ, L 191/22 of 19 July 2002.

3 Directive 2003/6 of January 28, 2003 of January 2003, OJ, L.96/16 of 12 April 2003

4 The definition is broader and addresses all persons that issue recommendations: see art 2, Directive 2003/125 of 22 December 2003, OJ L 339/73 of 24 December 2003

5 Text of the preamble 7, in fine. This refers to a strict separation of the "recommendation" activity from any other business activity, e.g. for financial analysts or rating agencies.

6 See art 6 Directive 2003/125, nt.4.

7 Art 6 (2) Directive 2003/125, nt.4; information about these measures should be disclosed.

8 Journalists are not subject to the same rules as applicable to financial analysts, provided they are subject to appropriate and equivalent regulation, including self regulation and provided the latter result in an equivalent effect as the one imposed by the directive: art 2(4) and 5(5) of the directive 2003/125, nt.4.

which they comment, would have to disclose said ownership. As the directive is formulated all “relationships and circumstances that may reasonably be expected to impair the objectivity of the recommendation” is to be disclosed[9]. The provision has been highly controversial on adoption and it will be interesting to see how it will be practised in the different states.

Some of the provisions on market manipulation also refer to conflict situations: in the case of “front running”, the broker takes advantage of his knowledge of the orders that clients have placed with him. Front running has not only an abusive effect on the market as it artificially increases the order flow and may mislead other investors, but also stands for a conflict between the intermediary and the investor. Here again, it is clear that although the rule primarily protects the investor’s interests, it also aims at protecting the confidence in the fair functioning of the market.

The Market for Financial Instruments directive[10] contains a specific section according to which investment firms – and in this case including banks[11] – are bound to take adequate measures to avoid conflicts of interest[12]. Investment firms and banks are bound to introduce organisational and administrative measures to identify and mitigate said conflicts and if these are insufficient, disclosure in general terms of the nature and the source of the conflicts has to be made to the clients.[13]

Furthermore the rules on “best execution” would also contribute to the protection of the investor against the conflicting interest of the executing investment firm which might have a tendency to choose for substandard execution venues, and hence may receive certain commissions or other advantages from the latter[14]. But here again efficiency of the market in general is primarily at stake. The best execution rules are not principally based on disclosure: true the investor should be able ex post to receive information about how the execution venue has been selected, but the obligations on the investment firms essentially deal with organisation measures, and procedures to select the best venue[15].

As the investment funds field is particularly prone to conflict of duties, one expects the directive to contain several provisions on the subject[16]. Already in the 1985 directive on investment funds, the functions of manager of the fund and of depositary of the fund’s assets were mandatorily split[17]: as the latter has a certain supervisory function, the split was imposed to avoid abuses, and at the same time introduce a useful monitoring mechanism[18]. The Amending directives of 2001 contain a general provision urging management companies to be organised and structured in such a way as to minimise conflicts of interest[19]. It expressly

9 Art 5(1) of the directive 2003/125, nt.4.
10 Directive 2004/39 of 21 April 2004, OJ. L. 145/1 of 30 April 2004
11 According to art. 1, Directive 2004/39 nt.10.
12 Art 18, Directive 2004/39, nt.10.
13 Art 18 (2), Directive 2004/39, nt.10.
14 See art. 21 of the Directive 2004/39; but the provision does not mention conflicts of interest considerations.
15 See CESR technical advice 05-290b.
16 To be mentioned here pro memoria: the management company must have internal rules dealing with employee transactions (art 5 f (1) (a); rules of organisation and structure to avoid conflicts between the management company, its clients or with other Ucits (art 5 f (1) (b).
17 Art 17(1) Directive 85/611 of 20 December 1985, OJ L 375, of 31 December 1985 stating that “no single company shall act as both investment company and depositary”.
18 Art 14 of the Directive 85/611 of 20 December 1985.
19 Art 5 f (1) (b); art 5 f (1) (a) relating to the conflict between the management firm and its employees, a subject on which all asst managers today have internal rules.

refers to the case in which the management company acts for several investment companies, and for other portfolios as well (private banking, institutional asset management), in which case specific rules preventing conflicts of interest have to be introduced[20]

But other conflict situations have not been dealt with: so e.g. can the management of the fund, the depository function and the sales organisation all belong to the same financial services groups, leading to the typically European structure of the investment fund business being overwhelmingly bank related. This feature of integration of the business in the overall banking organisation raises a certain number of conflict of interest issues, that are increasingly being tackled, in part by granting a large autonomy to the investment management business within the group, and by offering to the investors not only in house funds, but a selection of the "best" funds, within the "open architecture formula"[21]. Equally not tackled is the issue of the hard and soft commissions, which the fund manager receives from a broker in exchange of the order flow he directs to the broker: the commission can be in cash or equivalent, or may represent other advantages that are useful, whether to the business he runs, or to the manager himself[22].

Strikingly, the directive contains no overarching rule stating that the fund should be managed in the interest of investors, although a similar provision has been introduced relating to the depositary[23]. It introduces this idea indirectly by stating that the states should draw up rules of conduct reflecting the principle that the manager should act "honestly and fairly and in the best interest of the UCITS and the integrity of the market" and should further "try to avoid conflicts of interest, and when they cannot be avoided, ensure that the Ucits are fairly treated"[24]. By relying on state initiatives, the directive leaves ample freedom for member states to accommodate local situations[25].

A separate mention deserves the financial conglomerates directive, where the subject of conflict of interest issues is not mentioned as such but is indirectly addressed under the heading of "intra-group transactions"[26]. These have to be subject to supervisory overview by the coordinating supervisory body".

In the Insurance mediation directive[27], no mention is made of conflicts of interest, although evidently the matter might have been raised.

From this short – and necessarily incomplete - overview of the directives' provisions, one will conclude that on the one hand the directives contains several provisions that directly or indirectly deal with conflict of interest issues, that there is no consistent overarching approach, that certain matters – hard or soft commissions being the most delicate one – have on purpose been left out, while little or no structural measures have been provided for. Finally, the objectives of dealing with conflict issues ultimately aiming at protecting

20 See preamble 9, directive 2001/107 of 21 January 2002. Art 5 (3) of the directive.

21 See further part 4.

22 These issues are dealt with in national law: hard commission are generally considered unlawful, while for soft commission disclosure is usually considered sufficient. See e.g. the Belgian law of 20 July 2004, and Royal Decree of March 4, 2005, art.61, whereby only "soft" commission have been allowed.

23 Art 17(2) Ucits directive nt. 17.

24 Art 5 b, litt. a, Ucits directive nt. 17.

25 Art 5 h, litt. a and d Ucits directive nt. 17. The latter provision states that if conflicts cannot be avoided, the management company should treat the Ucits "fairly".

26 Art 8, Directive 2002/87 of 16 December 2002, OJ L 35 of 11 February 2003.

27 See Directive 2002/92 of 9 December 2002, OJ L.9 of 15 January 2003.

investors, whether by directly intervening in the relationship investor- investment firm or by insuring that confidence in the market is upheld. Both arguments – macro and micro – can be identified in several of the mentioned cases.

3. Why deal with conflicts of interest in financial services, especially in asset management?

Financial services regulation, especially in the collective asset management field, shows an undeniable interest for the issue of conflicts of interest. There does not seem to be one single philosophy, nor any overall statement to that effect. One should therefore analyse what are the policy objectives for these different interventions. These may be quite diverse.

An easy answer to the above question will be to refer to investor protection motives: although it is undeniable that investors would often be better protected with stringent conflicts of interest rules, it is not clear to what extent the present regulations aim at that. Most of the time the regulations impose disclosure on the conflicted party and rely on the awareness of the investor to discuss the disclosed matter and eventually to choose for an alternative. By imposing disclosure, the conflict is not avoided, it is merely mitigated. As often, investors have no alternatives, they can only compare the relative detrimental effects of conflict situations. By way of example, investment fund investors can only compare some of the charges imposed on the portfolio, but rarely can they avoid it altogether.

Should one not even wonder whether investors need conflict regulations? As was stated above, conflicts are numerous but also – as appears from some of the cited provisions - inevitable: hence, investors will take this for granted. They do not take investment decisions on the basis of the conflict disclosures, nor on the basis of the amount of fees received by the investment manager from their service providers – which might benefit investors by reducing the expenses or charges imposed on the portfolio manager and hence increase their return. Investors try to identify the best portfolio manager that is those that will yield the highest net return: whether more or less fees are received by the portfolio manager, is of less if any importance. As entry fees are quite different throughout Europe, one does not notice a massive interest for the funds with lowest fees, rather to the opposite. Also, the considerable higher management levied by hedge fund manager has not prevented this sector to have attracted very considerable amounts of moneys to be invested.

In terms of competition, disclosure of fees is important, but it is not sufficient. From the investor point of view, it would seem equally if not more important to be able to switch among funds: the comparison of returns of different funds can be expected to incite investors to arbitrate among them. Here the level of the exit fee[28] may represent a restriction. Rather than dealing with expensive or even burdensome conflicts of interest regulations, one could argue that it would be more efficient, and more protective of investor interests, if stronger competition allowed investors to switch funds at minimal costs[29]. The wide spread absence of no-load funds on the European markets can be mentioned in this respect[30]. Disclosure may contribute at least to make that element of the investment decision more transparent, and hence enhance competition.

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28 Or more precisely the fees for a "roundtrip", being both entry and exit fees.

29 It would be interesting to investigate if funds that do not charge an exit fee present a more volatile profile than those with an exit fee.

30 It would be interesting to identify how much the offering of load funds at no load conditions – what some banks do from time to time – would affect investor interest.

The entry and exit fees charged by investment funds vary considerably in Europe. Sometimes, even load funds are on offer at a zero entrance fee. It is not clear that investors do consider this factor as being of decisive importance for their investment decision. Much of their lack of sensitivity is due to the tying in of the investment business in the traditional banking groups: differently from the US, most investment funds in Europe are distributed not by the fund's distribution network, but through the traditional banking channels. Internet sales obviously have not changed that pattern. Products distributed by the banks are predominantly in house products: they are sold, not bought. Investors therefore rely on the reputation of the bank with whom they are dealing, less on the specific cost structure for entering or exiting the fund. Implicitly investors obtain – or think they obtain - some sort of guarantee that if matters go really wrong, the bank will stand behind. There have been a number of cases where exactly that happened: confronted whether with irregular dealings, or with a very unfavourable investment outcome, the bank stood behind and indemnified the investors. Conflicts of interest therefore also have some advantages!

The disclosures, to which most conflicts of interest situations will give rise, will not only protect the investors – at least presumably – but also affect the situation of the offeror of the service. By disclosing certain mostly sensitive items, it can be expected that some operators will avoid being exposed to public criticism and drop certain conduct: disclosed hard commissions will be omitted all together if their disclosure would create doubt about the receiver's fairness. The policing function of disclosure is a well known phenomenon, often synthesized under the expression that "electric light is the best of policemen". One cannot exclude that some parts of today's regulation have been conceived by its draftsmen as an invitation to market participants to present a fairer deal to the investors, e.g. by lowering their charges. The disclosure of soft and hard commissions, as discussed in some jurisdictions, can be mentioned in this context: it is not far from having been conceived as an outright prohibition, watered down in terms of disclosure. [31] Once again there is no evidence that this has been a successful approach in all fields. With respect to fund administration, both the number of charges and the applicable tariffs have increased. Entrance and management fees have a tendency to increase, managers arguing by referring to the fees charged on other markets.

The same argument could be reformulated in terms of reputation damage, as conflict situations belong to the group of abuses that is most damaging to public confidence. In the 1960s a major upheaval in the US investment fund sector was the direct consequence of discovering hidden commissions and other fringe benefits paid to investment managers by executing brokers[32]. The crisis has led to additional regulation, especially to additional disclosures. However a substantive prohibition was in general avoided: here again disclosure is considered an alternative to substantive regulation.

Financial services companies are increasingly sensitive not only to the existence of conflicts, but also to the public perception thereof, as these may damage their reputation and hence undermine their client's confidence. By stating that the firm avoids conflicts of interest it will enhance investor's confidence. Some operators mention this argument when offering investment funds within the "open architecture" form of marketing[33]. They present

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[31] See the FSA's position Bundled brokerage and soft commission arrangements, Policy statement 05/9

[32] See SEC, Public Policy Implications of Investment Company growth, 1966.

[33] See infra

themselves as independent advisors, selecting the best funds for their clients, irrespective of whether they are promoters of the fund, or mere salesmen. Even in this case, the bank would not be entirely free of any conflict: it remains silent on the commission it receives from the third party fund organisation.

The public authorities[34] in charge of monitoring the financial system strongly support the banks' action to avoid reputation damage. Although this action has originally been linked to money laundering, recent statements broaden the perspective and draw attention to the damaging effects of conflicts of interest. Large scale conflict cases may indeed damage a bank's reputation and in certain circumstances even jeopardize its future. If the conflict case affects not only one bank, but a large number of operators in the market, this might even trigger wider concerns, such as the competitive position of a national financial system. Dealing with conflicts of interest, although primarily a micro issues, has also a macro dimension in terms of reliability of the financial system and building investor's confidence in the soundness of its operations and structure. The quoted passage from the investment fund directive explicitly recognises this point by stating that the rules of conduct should ensure that the management company acts "in the best interest of the Ucits it manages and the integrity of the market"[35].

It is striking that in Europe, the fundamental structure of the investment management business has never been challenged on the basis of the existence of conflicts of interest. Even the directive admits that "conflicts of interest cannot be avoided", in which case a fair treatment has to be guaranteed to the investors[36]. Indeed, in Europe, one of the fundamental characteristics of the investment fund business is the embedding of almost all functions – portfolio management, distribution, order execution, distribution, and so on – within the banking group that acts as the promoter of the fund. At least theoretically this is to be analysed as giving rise to numerous potential conflicts of interest: the bank could advise to its clients funds for which it acts as its promoter; the fund's orders could be executed in house; cash could be deposited with the bank belonging to the group. Sometimes it has been stated that the bank may place some of the securities it has underwritten, or of which it want to divest itself easily in the portfolios of the funds of the group[37]. Conflicts between funds of the group, or between collective and individual asset management are underlying the new Ucits directives. And the number of conflict situations can be prolonged indefinitely. This structural issue has not been touched upon in the Ucits directive that has confined itself by stating a general principle and dealing with some specific items. Notwithstanding these numerous potential conflicts and investor's awareness about it, they do not hesitate to address themselves to their banks for investing their savings. The explanation of the passive attitude of investors has been mentioned above: investors consider placing their savings in a fund as entrusting savings to the bank, although legally the two are separate. Fund business is inherently banking business. This creates a potential risk for the bank, which can be mitigated by more clearly separating the asset management activity from the rest of the group's business. This type of structural intervention will be explored further in this paper.

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34 The Basel Committee on Banking Supervision regularly points at reputation risks due to conflicts of interest. Among its most recent statement see: BIS, Enhancing Corporate Governance for banking organisations, July 2005, Consultative Paper nrs. 18 e.s.

35 Art 5 h, cited above.

36 See art 5 h, litt d of the Ucits directive, nt. 17.

37 Wymeersch, E. and Kruithof, M., Belangentegenstellingen bij het beheer van gemeenschappelijke beleggingsfondsen, Revue de la banque, 1989, 303- 321.

To conclude, conflicts of interest in asset management are being dealt with in several provisions of financial regulation, most prominently in the field of investment funds. These rules address specific aspects of the problem, but not its inherently structural basis, which is due to the strong linkage of asset management with banking business. However, one sees increasing awareness of the structural dimension at least in some financial services groups.

4. Structural aspects of dealing with conflicts of interest in the field of asset management.

In this part of the paper, an analysis will be attempted showing that in some regulations, and more conspicuously in actual practice, banking groups are paying attention to this conflict of interest matter by taking structural measures, more particularly by separating the asset management business from the rest of the banking activity. The accompanying safeguards would deserve special attention.

(a) Regulation

At present there are some indications that also the European regulation has followed this path, although not in very specific prescriptions.

In the Ucits directive, this matter has been dealt with in structural terms only as far as the depositary is concerned: manager and depositary should be two different legal entities[38].
This is a clear internal control measure, especially so as the custodian has been put in charge of certain supervisory functions. The rule aims to avoid confounding the interests of the fund and those of the manager of the fund. But the approach is far from comprehensive: the custodian usually will be the bank that is part of the same financial services group, acting as custodian for the securities, receiving the cash in deposit, and guaranteeing the fund obligations when needed[39]. Other servicing activities will also be undertaken by group companies. From the clients' point of view- as stated above - this structure is not necessarily objectionable, as he invest his money with the bank, being under the form of a fund, a deposit, a short term bond, or in any other form.

Although based on wider considerations one could also mention the provisions in both the non-life and life directives prohibiting insurance companies to take up any business other than insurance business.[40] In view of the developments in financial services groups, one may wonder whether the economic justification of this prohibition is not likely to be challenged.

More explicit measures are called for in the Mifid: art.13 (3) provides that investment firms - including banks – should operate and maintain effective organisational and administrative arrangements with a view of taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of its client. This rule is further detailed in art.18, adding that in case the measures are ineffective, the investment firm "shall clearly disclose the general nature and/or sources of conflicts of interest r the client before undertaking business on its behalf". Finally the Commission will enact further detailed measures: these have not yet been adopted. As the provision has been drafted in very broad

38 The same rule is good practice in private banking.

39 This is the case with structured fund, as far as the "guarantee" for the capital is concerned.

40 See art 8(1) (b) of the Non-life directive 73/239 of 24 July 1973, as amended and art 8 (1) (b) of the Life directive 79/267 of 5 March 1979, as amended, where the limitation is strictly confined to life business, therefore excluding non-life.

terms it is unclear what its precise purport is, and whether structural measure of the kind referred to infra would be included.

(b) Factual developments

Recently some significant developments have taken place in several financials services groups whereby the asset management activity is being located in a separate subsidiary, more precisely a sub-group that is granted a well defined autonomy within the overall group. This development is due to different factors, among which specialisation, economies of scale, specific developments in the investment fund business have played a dominant role. But one cannot deny that conflict of interest considerations also have contributed to this development.

In practice, the awareness about the importance of adequately dealing with conflicts of interest is increasing in our societies. The number of regulations addressing conflicts of interest has increased, not only in the field of financial services but also in other domains as well. Some highly publicized investigations in the US have brought to light the various, previously unexpected forms of conflicts that occur in the financial markets. The traditional instruments – disclosure, Chinese Walls, conduct of business rules – are considered useful, but ineffective to avoid any suspicion of reproachable conduct. In recent insurance cases, controversy about commissions received by independent brokers raised questions about their role and has caused concerns that are being felt not only in the US but also in several European states. More strict disciplines are considered necessary.

If the existing instruments are ineffective to bring a satisfactory answer to conflict issues, what other measures can be taken to dispel any suspicion? The most radical answer has been developed in the asset management field. This answer is based on the strict separation between the asset management department of the bank and the rest of its business. It should be mentioned from the outside that this development is not only due to considerations related to conflicts of interest but responds – and probably more heavily - to organisational and efficiency imperatives at the same time.

The spectre of the now defunct Glass-Steagall Act has been revived: a split in the business is being introduced by spinning off the asset management activity – but not the entire securities business - into a separate subsidiary, with a separate board of directors, including independent directors, separate organisation, business plan etc. Often there even is a physical separation: the employees of the asset manager are located in buildings or even in states different from the main banking business. Their reporting lines are mainly financial (financial objectives, budgets) but not operational. With respect to the actual asset management, the company enjoys full autonomy.

Most larger financial services groups today have created, within the group a separate asset management entity, which is not dependent on the bank but acts as a supplier of asset management services whether for the group itself, or for the investment funds that are presented as group products. Usually this asset manager will be a separate company, a subsidiary not of the bank, but of the top holding company that also owns the shares in the bank, in the asset manager and regularly also in the group's insurance company. As an internal service provider it can be seen as a factory that produces products adapted to the wishes of the different markets where the groups' products are offered on sale. This tendency therefore also aims at considerable economies of scale and other specialisation imperatives.

How can one fit this development into the general organisational patterns followed in financial services groups?

Most of the large European financial services groups offer the full range of financial services: banking in its different forms, insurance, asset management and private banking, insurance, leasing and so on, all are part of the same group. For different reasons, especially regulatory, these services are located in separate legal entities, each with its own board of directors, management committees, external auditors, financial statements and so on. However, in practice the group is largely managed as a single "enterprise", often with centralised decision making at the level of the top holding company's management. Sometimes, one even finds the same persons taking part in the management committees heading the different legal entities, whether or not with a special representative of the entity itself. The management of the business of the group is organised, not according to legal entities, but according to business lines: the "retail" business line will look after the activities for the wider public e.g. in banking, insurance, personal banking and so on. Wholesale may be another business line. Business lines will therefore cut across several legal entities, leading to new and difficult legal questions. The coherence of the managerial structure, superimposed of the legal structure, deserves further analysis from the legal point of view. The rules on groups of companies will be a primary source on inspiration in this field[41].

As far as asset management is concerned, the situation is somewhat different: often it is considered as a group internal service provider. Its products are "sold" whether directly – e.g. management of institutional portfolios for third parties – or indirectly through the other parts of the group. This applies especially to investment funds, for which the asset management business line acts as a "factory" for setting up funds and managing portfolios that are then sold through the banking or the insurance arms often repackaged according to applicable legal, commercial or supervisory requirements and adapted to each of the geographical markets in which the group is active. The activity covers not only investment funds, but asset management for institutional investors as well. Usually private banking is kept separate, along with management of the group's assets for its own account.

The feature to be addressed here focuses on the independence of the asset manager within the overall group: increasing the degree of independence of the asset manager reduces the risk of possible conflicts of interest. By structuring the asset management as a more independent business within the group, the group wants to give the message that the risks of conflicts are addressed not so much by soft instruments – Chinese walls and the like – but by institutional measures, in fact the strongest that one can put in place. As far as the prudential approach is concerned, the structure indicates that potentially risky issues are receiving a strong institutional or structural response. In terms of protecting the investor's interest, the portfolios will be managed in an objective way, without any group interference. By conveying this message to investors, there is a hint that the group is aware of the previously widespread negative perception about the groups' conflicted position. But in the same time, it reduces the level of criticism that the bank is selling its own products: even if the products are in house, they are managed in an objective way, based on arm length's contracts.

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41 Among the fundamental notions, to be recalled here, is the so-called Rozenblum doctrine of the French "Cour de cassation", where the ground rules for group liability have been clarified. See: Forum Europaeum, Konzernrecht für Europa, ZGR, 1989, 672.

Looking into the details of the structure, one can firstly mention the strict legal separation of the management company (in fact often a subgroup) from the rest of the financial services group: separate name, although with a reference to the main group, separate legal regime[42], separate board, separate location, often spread over different jurisdictions. To contribute to this image of independence, asset management companies may usefully reinforce it by appointing one or more independent directors, whose task is to more specifically ensure that the management takes place in an objective, arms length way, thereby looking after the interests of all stakeholders.

The relationship with the group deserves further analysis: as a rule the group will retain full control, often at the 100% level. But it will not intervene in the actual investment decision, and the managing directors would very much insist on the group abstaining from any intervention in actual investment decisions: clients are informed that the assets are managed by a team that has no relationship with the overall group and takes its decisions in the interest of the portfolios managed, free from any influence of the bank.

However, through its membership of the asset management company's board, the group will not stand aloof: it will ensure that its overall objectives are realised in terms of strategy, return on group investment, of budgets, of results but also in terms of group policies involving the group's reputation. As the products of the asset manager usually carry the name of the group, they may harm the group's reputation in case its guidelines are not strictly adhered to. Part of this reputation issue relates to respecting the policies that are developed at group level, and aim at insuring that the standards of ethical conduct are abidden by all group entities wherever their business activity. These are becoming more and more important: apart from money laundering policies, ethical or responsible investment have become points of considerable attention. Avoiding conflicts of interest will be part of these standards. Transactions with professional counterparties – e.g. for cash investment, order transmission, financial analysis, etc – will take place on an arm's length basis and only after having tested the conditions of different market participants, whereby the group will not enjoy a privileged position. Sometimes, the "factory" will assemble products for third parties that are then sold under that party's name: here it is evident that any bias in the management would scare away any partner.

Apart form the mentioned items the group's overall intervention will also extend to the supervision of the activities of the asset management team: internal controls, audit, compliance rules will all be determined and enforced on a group wide basis, and be monitoring by departments belonging to the overall group, and this notwithstanding the sub group's own internal control mechanisms.

As far as conflicts of interest are concerned, the message is clear: all conflicts of interest are to be avoided. But conflicts of interest are of course not the only, probably not even the principal reason for organising a separate asset management business line: it is also influenced by regulatory concerns, such as the requirement to organise a separate asset management company for investment funds. This requirement will be further strengthened under the recent Mifid rules that will lead to applying stricter conflicts rules.

To what extent this structure will constitute an effective response to accusations of biased conduct is difficult to say. The relationship with the banking group will continue to exist: ultimate policies will be decided at group level, personnel will move between different

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42 Whether investment firm in the sense of the Mifid, or a specialized Ucits management company.

departments of the overall group, procurement contracts such as insurance coverage will be directed for the entire group. Will the presence of one independent director for all portfolios managed constitute a credible defence again accusations of unfair treatment? Even if the answer to some of these questions remains unsure, the overall movement is towards more autonomy of the asset manager in the banking group.

Another development points in the same direction, i.e. the offering of investment funds within the concept of the "open architecture". Some banks have decided to offer not only in house products but also products of other selected asset managers. They indicate to their clients that they have selected the best products on the market, and that clients can choose among them, sometimes at lower entry fees. The role of the bank has changed from managing funds, towards selecting the best performing funds, and to advising clients in function of their needs. This marketing is, according to some banks, likely to become the prevailing approach for marketing investment funds. It eliminates the conflicting interest of the bank, and limits its financial involvement to receiving a fee, the gross amount of which may – or may not - be known to the client. In practice the open architecture agreements often contain a more elaborate agreement among the banks, whereby the offering bank will undertake a due diligence of the other bank's management services, evaluate the quality of its staff, procedures, organisation, and of course also of the returns obtained. Sometimes agreements allow products to be sold on a reciprocal basis. Here again questions of conflict might appear, but are mitigated due to the comparative analysis and adequate disclosures. Even if insiders would contest that this development reflects the same fundamental drive towards a less bank- embedded asset management, the banks claim that by choosing for the "open architecture" approach they are more independent, free from any bias.

Some groups have reflected on other combinations: while maintaining a separate asset management entity within the group, they wonder whether the group should keep full control of the asset manager that is in any case functioning in a largely autonomous way. They wonder whether – also for reasons of economies of scale – joint ventures, or even mergers with other asset managers could not yield a higher return on capital invested. Here the logic of spinning off the in-house asset management has been pursued to the extreme: the original banking group would retain a minority stake in its former asset manager, and sell its products along with those of other suppliers. The role of the bank becomes that of a neutral marketing channel, identifying the products that offer the best returns and looking for the best fees on products sold. At the same time the group may develop a wider range of products on offer, reduce its investment and achieve a lower cost factor.

It is still premature to present the last trend as clearly present. From the angle of the present research, one can state that financial services groups, while attempting to eliminate conflicts of interest, are presenting a credible product range to clients.

To conclude, apart from the complex legal requirements that aim at avoiding conflicts of interest or at least at streamlining them, the economic structure of the sector seems to be heading towards more institutional or structural concepts whereby the conflicts arising for the asset management activity within a banking group are largely eliminated. The tendency underpins the drive of banking groups to gain the confidence of their clients and to avoid any reputation risk. It does not mean that all conflicts are eliminated. If the trend would be further confirmed, one may be moving to a scheme that is closer to the US-UK scheme, where asset management is not necessarily located within banking groups.

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