“Conflicts of Interest Among Market Intermediaries”

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Conflicts in Goals are Inherent

- The “Principal-Agent” (Agency) paradigm is one of the central tools in modern economics
- It reflects many aspects of commercial relationships
- Only in certain instances does the resulting behavior violate acceptable norms and become problematic
- An additional disclaimer: This is an economics rather than legal perspective (we’re not attorneys)

The “Principal—Agent” Paradigm

- The incentives of the “Principal” and “Agent” differ in many problems with delegated decision-making
- The agent undertakes actions for the principal
- The decisions of the agent (even “effort”) are often hard to monitor (“unobservable”)—considerable discretion and limited disclosures
- Differences in risk preferences
- The agent’s “participation constraint” and the competitive marketplace

Why do the Business Goals of the Principal and Agent Differ?

- The investor (the principal) cares about his net of fees risk-adjusted return (role of “payment”)
- The adviser (the agent) cares about his fees and especially about growing his business—How does he get paid?
- The flow-performance relation is “convex” so that the adviser has strong incentives to add risk
- The adviser is in a “tournament”—which may increase the incentives for risk-bearing—institutional advisers tend to compete against others with similar strong performance

Multiple Business Lines

- Economies of scope, synergies are important
- Conflicts because of multiple business lines are relatively common
- The business structure may reflect economies of scope, but lead to potential conflicts—these are not necessarily "negative"—basic aspects of the broker-dealer business
- Alternatively, the business structure may have developed to exploit conflicts—e.g., payment for order flow

Information Production

- Gathering of information is relatively central to key aspects of financial services,
- For examples, analysts play an important role in brokerage, underwriting, asset management and credit rating
- Information creation difficult to outsource
- Will independent analysis turn out to be a viable business model?

Conflicts of Interest are Inevitable

- Conflicts of interest are relatively pervasive and inherent
- The structure of conflicts in the market equilibrium may be important
- Dealing with an individual conflict in isolation may not be best
- The structure of an industry may evolve in response to managing the conflict efficiently and the structure of regulation—Example, delegated monitoring and financial intermediaries

Example: Disclosure of Mutual Fund Votes

- **Underinvestment in evaluating how to vote since the benefits would mostly flow to other investors vs. investing in forming a more effective portfolio**
- **Unintended effects from disclosure—potential for punishment from the firm and from third parties**
- **Disclosure leads to hiring intermediaries to improve decisions—natural scale economy—but intermediaries conflicted due to their business models**
- **If goal is better decision-making, then one might want to empower activist investors—however, that would leave investors vulnerable to other agency issues as illustrated by the possibility of greenmail**

Examples of the Evolution of the Structure of an Industry

- Payment for order flow
- Independent analysts and research
- Soft dollars
- Auditor independence and the equilibrium structure of the auditing industry
- The industrial organization of a market may respond to the economies of scope as well as the conflicts of interest

Conflicts among Multiple Principals

- The agent (adviser) often works for multiple principals (accounts):
- The agent’s payoff can have different sensitivities to its principals (accounts) due to such factors as incentive compensation, different management fee rates, the effect of past performance and the shape of the flow for performance relationship and spillovers from “Star” funds.
- Favor one client over another and allocate profitable trades to favored client

Economies of scope

- Economies of scope are not necessarily huge, but the costs of specific conflicts may not be huge either—an example is the case of a hedge fund that owns a seat on an option exchange

Product Distribution

- The advisers' incentives reflect his fee—conflict with the investor who "pays" the fee!
- Yet the customer needs to pay for distribution and "education"—The fee-based model is one approach to financing. One should not ignore the reality of financing.
- Will the adviser recommend products for which he is not directly paid? This may depend upon the overall structure and history of the relationship.
- "Suitability" and "churning" are at the heart of many arbitration cases—Examples of "problematic" agency

Conflicts across product lines

- Favors clients in one line of business over others
- Example: Recommend marginal IPOs to retail brokerage customers to support investment banking client
- What duty does the firm owe various types of clients? The adviser vs. the broker model—the nature of the agent’s fiduciary obligations

Taxonomy of Conflicts of Interest

- Simple principal-agent conflicts
  - Agent favors self ahead of clients
- Conflicts across multiple principals
  - Agent favors some clients over others
- Conflicts across product lines
  - Agent favors one line of business over others

Simple principal-agent conflicts

- Executives setting their own salary and benefits
- Unauthorized perks/ shirking
- Insider Trading
- Broker churning to generate commission
- Broker recommending high-commission funds
- Broker front-running customer orders
- Trading managed assets to benefit own position
- Fund adviser growing assets beyond optimal size

Conflicts across multiple principals

- Allocation of IPOs to favored clients
- Cross-client trading
- Allowing one client to front-run another
- Allowing one client to arbitrage against another
- Ex-post Trade Allocation

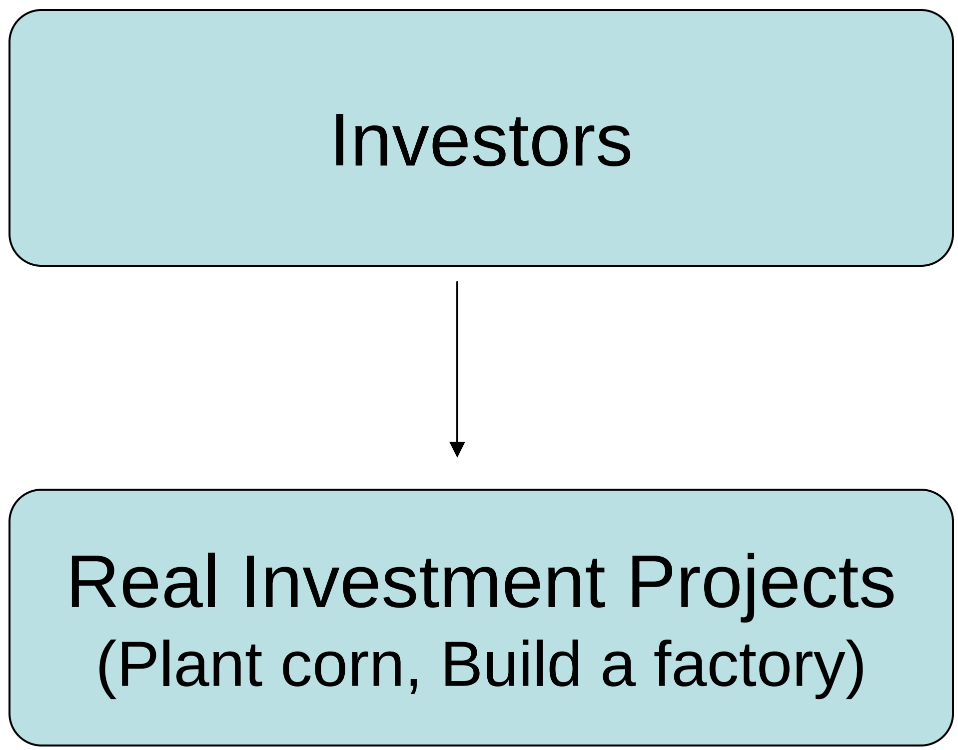
Example: Trade Allocation

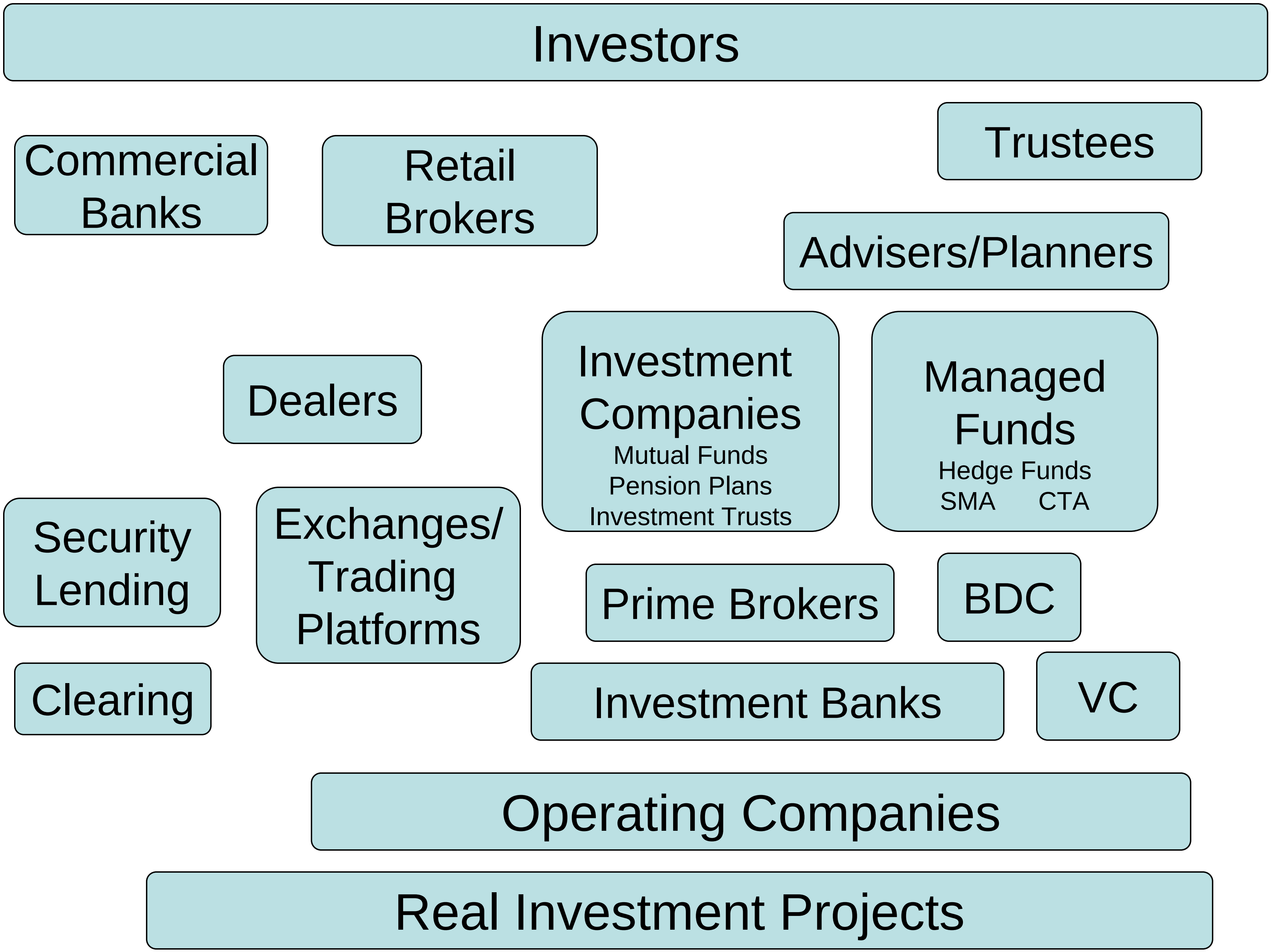
- Money manager has clients A and B, in Separately Managed Accounts
- Buys a stock at 9:00 AM
- At 4:00, assigns the trade to client A or B
- If stock went up between 9:00 and 4:00, assign the trade to client A
- If stock went down, assign trade to client B
- Economically equivalent to stealing money from B and giving it to A

Conflicts across product lines

- When the same firm is involved with multiple lines of business, they have different categories of clients
  - Some business lines more profitable than others
  - Some customers more sophisticated than others
- Temptation to transfer wealth:
  - toward more profitable lines, at the expense of less profitable lines
  - Especially if the losers are unsophisticated

Econ 1


Investors
Real Investment Projects
(Plant corn, Build a factory)


Investors
Commercial Banks
Retail Brokers
Trustees
Advisers/Planners
Dealers
Investment Companies
Mutual Funds
Pension Plans
Investment Trusts
Managed Funds
Hedge Funds
SMA CTA
Security Lending
Exchanges/ Trading Platforms
Prime Brokers
BDC
Clearing
Investment Banks
VC
Operating Companies
Real Investment Projects

Other Specialized Functions

- Regulation
- Insurance
- Financial Analysis
- Auditing
- Risk Management / Derivative Securities
- Bond Rating
- Cash Management
- Shareholder Services
- Strategic Consulting
- Fund Evaluation
- Custodial Services
- Fund Distribution
- Pricing Services
- Portfolio Analysis
- Transaction Cost Analysis
- Index Services
- News Reporting
- Market Data Services

Investment Banking/ Fund Management

- An investment bank underwriting an IPO is also managing mutual funds or hedge funds
  - They can force fund to buy shares of overpriced IPOs
  - They can allocate hot IPOs to their own funds

Investment Banking/ Financial Analysis

- Financial Analysts are supposed to provide objective research reports/ recommendations
- Firms that also do investment banking business with a company may have an incentive to give overly optimistic research reports.
  - See Michaely and Womack (RFS, 1999)

Auditing/Consulting

- Accounting firms are supposed to provide an independent assessment/verification of the operating company's financial statements and accounting procedures
- If the same firm also provides consulting services, they may have an incentive to compromise their auditing standards

Broker/Dealer

- When a firm is acting as a broker facilitating customer traders and also engaging in proprietary trading
  - They might internalize trades at prices unfavorable to their brokerage customers
  - Proprietary traders might engage in front-running of customer order flow
  - Trading in front of research reports
  - Pump and Dump Schemes

Broker/Fund Manager

- Brokers steer clients into funds managed by their own firm, even if it is a bad choice
- They might internalize trades of their brokerage clients against their own mutual funds
  - Give brokerage customers bad executions to benefit mutual fund customers
  - Give mutual fund trades bad executions to benefit brokerage customers

Financial Adviser / Fund Sales

- Brokers and Financial Advisers are paid commissions to sell shares of mutual funds
- This creates an incentive for them to recommend funds with high commissions

Pension Plans

- Fund families compete with each other to run corporate pension plans
  - Fund managers might be overly inclined to vote shares in favor of the firm's management, even if it is against the interest of shareholders
  - Fund managers might be induced to invest fund assets in the firm, even if they think it a bad investment

Regulatory Approaches (depends on enforcement ease, legal code)

- Caveat emptor
- Board and auditor oversight
- Self-Policing (and repeat relationship as with “SROs”)—Self-reporting, chief compliance officer examples
- Policies and procedures
- Disclosure
- Rules against specific abuses--compliance, enforcement
- Information barriers (“Chinese wall”)
- Complete separation (auditor vs. consultant; independent analyst)

Ethics at the SEC

- Self-responsibility—specific restrictions
- Disclosure (confidential and public)
- Information barriers
- Prohibitions

Policies and Procedures example

- Clearly stated policy and procedures are helpful
- These limit needless “discretion” and articulate to all (internal, customers, regulators) the “intent” and “procedures” of the firms—Useful for both marketing and internal management
- It becomes easy to assess the policy and audit “compliance”
- Some “problems” (e.g., ex post trade allocation) are avoided by sensible policies

Agency Theory: A Valuable Lens

- Unified framework for understanding economic decisions and compensation arrangements
- Sources of agency conflict—Fee and compensation relationship, diverse risk aversion, business models, multiple principals
- Examples from asset management