Re-Examining Investor Protection in the EU and US

John JA Burke
“Information is the most important commodity I know of. Wouldn’t you agree? You know why the average fund manager can’t beat the S&P 500? Because they’re sheep, and sheep get slaughtered. I don’t throw darts at a board. I only bet on sure things.”

Abstract

The year 2009 is a propitious time to evaluate systems of investor protection in financial markets as global bank losses exceed the 1 trillion mark and market losses equally exceed the 1 trillion mark. Prior to the Global Financial Crisis, the European Union enacted sweeping legislation to reform its system of investor protection. The Markets in Financial Instruments Directive [MiFID] is the regulatory equivalent of the deregulatory 1987 “Big Bang” that shaped the current European financial markets. It also applies to one of the world’s largest trading regions. This article examines select investor protection provisions of MiFID and their analogues in US securities legislation. Part I sets forth the macroeconomic function of financial markets as an essential perquisite by which to measure the likely effectiveness of investor protection provisions. Part II sets forth two models of investor behaviour. Part III describes paradigmatic theories of investor protection. Part IV critically assesses the paradigmatic theories of investor protection. Part V undertakes a comparative analysis of the principal investor protection provisions of MiFID and their US analogues. Part VI summarises the conclusions reached by the foregoing analysis. MiFID reinvents and improves its predecessor, the Investment Services Directive, and tracks commercial developments in the marketplace. Its vaunted investor protection scheme cannot protect the investor against the most significant factor driving prices of financial instruments: the dark pool of unknown and unknowable contingencies.
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Introduction

Scholars have published numerous articles on MiFID, described as “the most significant European Union legislation for investment intermediaries and financial markets ever introduced”, and have referenced select US analogues.6 These articles generally focus on the capacity of MiFID to consolidate the European markets, to promote the single passport for financial intermediaries, to make the markets more transparent, to bolster investor confidence through prohibitions against market abuse, increased disclosure, and the mandatory and novel client classification scheme. This article does not fundamentally agree with the glowing observations and conclusions. The recent global financial crisis has demonstrated that a fundamental assumption of MiFID is false: the need to interpose a “professional investment advisor” between the investor and the markets. Countless examples from history related to scandals and market crashes support this contingent truth. The comparable US investor protection scheme equally fails to achieve its objectives. Despite the countless tinkering with SEC rules, retail investors are fodder for institutional firms. The question remains are the investor protection provisions of MiFID an investor blessing or an investor execution. Similarly, the question remains is investor protection rules under the US system ripe for reconsideration and reconstruction. This article therefore re-examines the fundamental assumptions underlying capital markets and the paradigmatic approaches to investor protection.

Part I. The Macroeconomic Function of “Financial Markets”

Analysis of investor protection principles requires an understanding of the macroeconomic function of “Financial Markets.” Financial markets exist primarily, though not exclusively, to facilitate the transfer of funds from “surplus economic units” to “deficit economic units” within a financial system.7 The reason: to finance the factors of production thereby expanding Gross Domestic Product and increase in social wealth. Comprehending “financial markets” and financial instruments therefore is required to assess the potential of investor protection principles to achieve their stated objectives.

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Most societies adopt policies and strategies designed to result in economic growth as measured by the percentage annual increase in real GDP. There are two major components to GDP increase: (1) capital accumulation and (2) technological progress.\(^8\) Capital accumulation encompasses two factors: first of increasing the factors of production: land, labour, and capital, and second of applying additional capital per worker to increase productivity growth. Technological progress is the *sine qua non* of GDP growth. It takes two forms: (1) major discoveries [rare], and (2) research and development.

The economic role of financial markets is to provide the factors of production with the finance essential to make investment decisions that will lead to real GDP increase. Conventional wisdom accepts that “a strong financial sector act[s] as an engine of growth.”\(^9\) That premise follows from the work of Levine and Zervos, concluding that “stock market liquidity – as measured both by the value of stock trading relative to the size of the market and by the value of trading relative to the size of the economy – is positively and significantly correlated to current and future rates of growth, capital accumulation, and productivity growth”.\(^{10}\) The ability to “trade ownership of an economy’s productive technologies facilitates efficient resource allocation, physical capital formation, and faster economic growth”.\(^{11}\)

However, these conclusions are subject to qualification.\(^{12}\) Equity ultimately may be an unimportant source of capital.\(^{13}\) Once stock is issued and used to invest in real resources, it is neither depreciated nor consumed. It does not add one pence of additional investment capital to a company’s capital structure. Rather, trading in the secondary market reallocates wealth among investors buying and selling financial products, “as parimutuel wagering reallocates wealth among bettors at the racetrack”.\(^{14}\) In addition, empirical data proves that unprecedented GDP growth may

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\(^{11}\) Levine and Zervos, n 10, p 575.


\(^{14}\) Stout L.A., n 13, p 644.
take place in the absence of a securities market.\textsuperscript{15} The causal role of law in financial development is the subject of numerous studies by finance and legal experts, predicated upon the landmark work of a group of financial economists referred to universally as LLS&V.\textsuperscript{16} In the European Union context, Elis Ferran raises identical questions about “law’s role in the building of an integrated EU securities market”.\textsuperscript{17} While this article does not examine whether “law matters”, it does touch upon law’s role in the development of institutional infrastructure essential for capital accumulation and technological progress.\textsuperscript{18}

a. Types of Markets

In his seminal work, \textit{Capital Markets Law and Compliance: The Implications of MiFID}, Nelson implies by the exact title of his book that MiFID inexorably is limited to “capital markets”.\textsuperscript{19} However, capital markets refer to long-term securities, thereby excluding “money markets” to which MiFID explicitly applies. Though this distinction is a minor nuance, and conceivably a choice to select an attractive book “Title,” nevertheless it demonstrates the need of law and finance professionals to use a common vocabulary to provide precision and clarity to their work for purposes of deconstructing and interpreting the meaning of legal texts.

Markets are conventionally divided as follows: primary markets, and secondary markets. They are further sub-divided as: (1) capital markets, (2) money markets, and (3) Over-the-Counter Markets.\textsuperscript{20} In addition, since the decline of national exchanges and the relentless innovation in financial markets, “electronic communication networks” [ECNs] and other alternative trading systems have developed to provide investors with choice: lower transaction fees, automated order matching, and 24 hour

\textsuperscript{15} \textit{E.g.}, the economic performance of Latvia, Lithuania and Estonia, countries that do not have any significant exchanges, have consistently increased GDP by more than 10% for several consecutive years. The economic growth of the United Kingdom, France and Germany combined do not equal these numbers.


\textsuperscript{18} The causal role of law in market development is beyond the scope of this brief except to the extent, without reliance upon empirical or statistical analysis, the merits of MiFID may be measured against its objectives.


\textsuperscript{20} Gallagher T. and Andrew J., n 7 at 26-27.
trading. While the traditional securities exchanges are larger than their alternative counterparts, technological progress consistently present a competitive threat to organised exchanges, thus fostering innovation. Traditional “Securities Exchanges” take three forms: auction [New York Stock Exchange], dealer or quote driven [NASDAQ, the London Stock Exchange, for example], and order driven [Paris Bourse].

With the exception of the London Stock Exchange, the European Union lacks critical mass in any stock exchange to take a significant share of the world market. The fact that NASDAQ now owns OMX [NASDAQ OMX] and the NYSE owns EURONEXT further erodes the importance of European owned organised exchanges, and it logically follows, Europe as a significant money centre. The table set forth in Appendix A demonstrates that the combined value of the NYSE EURONEXT and NASDAQOMX accounts for 59% of the total market capitalisation of companies in the major world markets. By contrast, the LSE represents 0.07% of total market capitalisation. The point of this illustration is not to disparage the EU, but rather to set MiFID in its real context, to evaluate and judge the Directive’s capacity to: (1) stimulate financial market activity, particularly with respect to the retail investor, (2) reflect developments in the markets, and (3) create a unified EU cross-border market in securities.

b. Types of Instruments

Securities are the instruments through which funds move through the financial mediation system underpinning the economic function of financial markets. The two basic forms of securities are: equity and debt. Even these fundamental instruments may display sophisticated characteristics, for example, convertible debt, preferred stock, and classes of equity; the mathematics needed to assess risk, return, and yield, even on these “simple instruments,” is beyond the knowledge of most retail investors.

21 ECN’s are attractive because they cut out the middleman [disintermediation]. They resemble the business model of “Ebay.” Orders sent through brokers appear within seconds on ECN screen along with all other orders. ECN’s make money by charging a per-share fee.
22 Mathias M. Siems, The Foundations of Securities Law, European Bus. L. Rev., Vol. 20 (2009) pp. 141-171 providing an elegant account of the origin and development of securities exchanges and explaining the emergence of trading securities outside the traditional exchanges, such as the OTC and ATS markets, and delineating the advantages and disadvantages of fragmented markets.
23 A table of twenty “Stock Exchanges” set forth in Appendix “A” showing market value places the discussion of MiFID in a global context.
Rudimentary derivative instruments, such as options and futures, representing the tip of the iceberg within the critical area of derivative instruments, rest squarely with the professional to understand and use properly to optimise a portfolio of assets. MiFID applies to myriad instruments traded in the financial markets as set forth in Section C of Annex 1 of the Directive. A brokerage account opened in the United States generally permits the account holder a large margin of discretion to construct an investment portfolio, without imposing the paternalistic restrictions required by MiFID.

c. Financial Intermediation

“When funds flow from surplus economic units to a financial institution to a deficit economic unit, the process is known as intermediation. The financial institution acts as an intermediary between the two economic units.” 24 Major financial intermediaries are: banks, insurance companies, investment firms, pension funds, and collective investment undertakings [Mutual Funds: US; UCITS: EU]. The major deficit economic units are government and firms. The function of financial intermediaries is to draw funds from numerous small surplus economic units, pool their resources into large funds, and purchase securities from, and/or lend capital to, firms and government. The services of financial intermediation range in cost, and when an initial public offering is involved, the flotation costs to the firm are substantial.

Without getting into the nuts and bolts of order routing of customers’ orders, the practice of executing an order “in-house” requires discussion because of the important role it plays in MiFID and in US legislation and practice. Large brokerage houses, such as Charles Schwab and Merrill Lynch, often do not route client orders to market venues, but match buy and sell orders internally or draw upon their own inventory to execute the trade. In principle, there is nothing wrong with this practice provided the firm acts consistently with its duty of best execution. MiFID defines a firm engaging in this activity a “systematic internaliser”, and provides a “systematic internaliser means an investment firm that which, on an organised, frequent and systematic basis,

24 Gallagher T. and Andrew J., n 7, p 45.
deals on own account by executing client orders outside a regulated market or an MTF”.

d. Role of Investors

Law properly distinguishes between institutional and retail investors. The former require regulation to ensure adequate capital reserves, to protect against fraud, and to prevent systemic failure of the financial system. The latter require protection to ensure that the markets provide a level playing field, to assure that market prices are not manipulated and are set by material information about listed entities, and to provide effective remedies against violations of trust and breach of market rules. Investor protection legislation is designed to induce retail investors to take risks.

The macroeconomic function of financial markets and investor protection are inextricably related. One observer has succinctly stated the connection in the “modern context”:

“In the modern economy, the intermediary’s brokerage services are essential to matching suppliers and issuers of capital, and these securities intermediaries inhabit a position of relative trust and confidence vis-à-vis their capital supplying clients. Empirical evidence shows that the rise in financial intermediation bears a direct correlation with economic development, as financial intermediation is closely related to the growth of capital markets”.

Consequently, this article, prior to assessing the merits of investor protection principles, describes and criticises theories of investor protection, and selectively compares EU and US approaches to governmental market intervention. This larger context creates the analytical framework required to understand MiFID and its likely effects on building a EU securities market.

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26 Chiu L., Securities Intermediaries in the Internet Age and the Traditional Principal-Agent Approach Model of Regulation: Some Observations from European Union Securities Regulation, (2007) 2 Va. L. & Bus. Rev. at 307, 309. This brief does not enter the deeper, and complex, debate about whether law does or does not matter to financial market performance. E.g., see Ferran E., n 17 pp 8-57.
Part II. Two Models of Investor Behaviour

Professor Lynn Stout identifies two models of investor behaviour: (1) the rational expectations investor, and (2) the trusting investor. She assumes and, correctly so, that investors invest to make money. However, she asks a deeper and more difficult question: why do investors believe they will profit by making investments in the financial markets. Empirical evidence bears out questioning that assumption. For example, in period between 2000-2003, NASDAQ lost approximately 75% of its total market capitalisation. The recent global financial crisis equally pierces a searing hole in this belief system. Lehman Brothers, a notable Wall Street investment bank went bankrupt, thereby undercutting the assumption that the professional money manager knows its business. Merrill Lynch, a widely known securities firm that, arguably if it had a EU counterpart, would function as an institutional shield of investor protection, lacked the judgment to maintain the company as an on-going concern, forcing it to be acquired by Bank of America. The conventional answer to this question is the model of investor behaviour called the “rational expectations” investor model.

a. The Rational Expectations Investor Model

According to the rational expectations model, “investors behave like members of the species homo economicus: they are cool, calculating and purely self-interested actors”. The rational investor also assumes that other participants in the market, such as corporate managers, brokers, money managers, are equally calculating, self-interested actors in the marketplace. Therefore, using Professor Stout’s analogy, the rational investor approaches the markets as one would approach a chess game. It is

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assumed that, given the opportunity, the adversary of the rational expectations investor will steal his/her money, as a chess champion would take a queen if exposed. Consequently, under this model, the rational expectations investor will not part with its hard earned cash without adequate restraints placed upon the corporate managers, brokers, and money managers.

The following quotation poignantly captures this dichotomy:

“This means that a rational expectations investor will only be willing to plunk down her hard earned dollars to buy stocks, bonds, mutual fund shares if she is presented with evidence sufficient to persuade her that corporate insiders, and securities professionals face external constraints adequate to discourage them from stealing and shirking, and external rewards sufficient to give them incentive to run their firms and clients’ portfolios well and profitably. To return to the chess analogy, the rational expectations investor will not move her queen to an open space on the board until she is sure the other player can’t take it. Rational expectations investors do not invest on faith. They take nothing for granted.”32

Since the rational expectations investor presumes that corporate insiders and securities professionals would not hesitate to lie, cheat or steal, this model requires a legal regime that constrains corporate opportunism. If the legal system lacks effective external constraints, the rational expectations investor will withdraw from the market, refusing to invest. This model necessarily adopts the Efficient Capital Market Hypothesis, maintaining that the price of securities accurately reflects their intrinsic value. Without that implication, the rational expectations investor will not purchase securities, as the investor will lack evidence of quality investments.

The rational expectations investor model has shaped several legal regimes in the construction of investment protection. A notable example of this argument emanates from a landmark article by Professor Roberta Romano in the Yale Journal.33 In her article, Professor Romano argues that the United States should permit corporations selling financial instruments to select the legal regime, under which they would be regulated, conceivably even regimes countenancing fraud. She argues that a rational expectations investor would shirk away from any unprincipled legal system, as the rational expectations investor requires effective external constraints against corporate

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opportunism. She says, “it is silly to contend that investors will choose regimes that encourage fraud”. 34

Professor Romano’s theory demonstrates how the rational expectations investor model has shaped discourse in the domain of securities policy. Judge Easterbrook, in an article written when he was a professor at the University of Chicago, went so far as to say that the argument that securities laws are necessary to protect unsophisticated investors is “as unsophisticated as the investors it is supposed to protect”. 35

Yet, the legislative evidence of any sophisticated legal regime supports a contrary viewpoint and argument. For example, in the United States, post-Great Depression legislation such as the 1933 Securities Act and the 1934 Securities Exchange Act, and the plethora of subsequent amendments and laws designed to protect the investor undercut the rational expectations investor model. The European Union is not different, as evidenced by the Prospectus Regulation, the MiFID Directives, and the Market Abuse Directive. 36 The mandate of disclosure and laws forbidding fraudulent market activity serve as the backbone of investor protection in the financial markets. 37

b. The Trusting Investor Model

A trusting investor has faith that at least some people are trustworthy. This behaviour generally is based on past positive experience. If a person has behaved cooperatively and honestly in the past, the trusting investor assumes that the other person’s behaviour will continue into the future. Professor Stout remarks, “(Economists sometimes describe this sort of backward-looking analysis as adaptive expectations to distinguish it from rational expectations)”. 38 Trusting investors expose themselves to

34 Romano. R., n 33 p 2368.
37 Regrettably, the legal infrastructure is less than fully effective at achieving its goals. Typically, it is reactionary, responding to incidents after they occur, and often the speed at which the Legislator acts may produce misguided legislation such as Sarbanes-Oxley, even though the EU has adopted what may be termed a “mini” Sarbanes-Oxley” act, subsequent to the EU outcry against the US legislation when first enacted.
betrayal and fraud at least once, in contrast to the rational expectations investor. The fleecing of the trusting investor is likely a one-off proposition. Quoting Mark Twain, “We should be careful to get out of an experience only the wisdom that is in it – and stop there; lest we be like a cat that sits down on a hot stove-lid. She will never sit down on a hot stove-lid again – and that is well; but also she will never sit down on a cold one any more”.39

Anecdotal evidence, and common sense, suggest, if not demonstrate, that most investors in the financial markets behave as trusting investors. Reasoning by negative implication proves this statement. Distrustful investors, that is, rational expectations investors, would avoid the markets. The information costs that the rational expectations investor must expend would discourage, if not persuasively convince, the rational expectations investor to abandon the market, given the size and complexity of modern securities exchanges and the diversity of products. Even if the rational expectations investor were to invest in a small portfolio of stocks, the number of people in a position to lie, cheat or steal is substantial and the rational expectations investor would want confirmation that at each stage effective external constraints were in place to prevent fraud. This hypothetical demonstrates that the costs outweigh the benefits, thereby confirming that the majority of market investors fall under the Investor Trust Model.

However, this hypothesis, if correct, has major implications for the market, as once burned, the trusting investor will not return to the market, as Mark Twain’s cat, once burned, will not sit on a stove-lid even if cold. Recent incidents, as well as history, do not bode well for the trusting investor model. While many instances of misconduct by corporate insiders and investment specialists may be cited, Enron and WorldCom provide paradigmatic examples of the scope and severity of harm corporate opportunism can visit upon the trusting investor, including employees exercising stock options, and outside investors purchasing stock relying upon the recommendation of insiders and outsiders.40 These two cases, involving both unethical and illegal behaviour, no longer constitute an anomaly in the market, but

39 Twain M., *Following the Equator* (1897) p 124.
represent the tip of the iceberg of mismanaged companies, misleading information, and the incompetence of “experts” to protect the public.

Responding to the question of why investors purchase securities, Professor Stout states:

“The answer is trust. American investors take it as a matter of faith that the brokers and mutual fund managers to whom they entrust their savings will use those funds to actually purchase securities on their behalf. They take it as a matter of faith that corporations that issue securities really exist, have real assets and make real profits. Because they have faith, American investors buy trillions of dollars of corporate securities each year, even when they are not quite sure what they are buying. [footnote omitted] One could not ask for a more instructive example than Enron. Before its sudden and shocking collapse, the firm was routinely cited as one of the best run and most innovative companies in America, even though neither the shareholders who owned the stock nor the analysts who followed its progress really understood how Enron made its money”.41

This analysis of two models of investor behaviour poses sobering results. On the one hand, the rational expectations investor model, given its strict requirements, is an implausible explanation of why so many investors purchase securities in the market. On the other hand, the investor trust model is fragile, and a series of betrayals, will result in the investor leaving the market, as the betrayed investor will not subject to risk serious investments, such as those related to retirement funds. Prolonged bear markets are detrimental to the investor and provide incentive to search for alternative investments. Having established that the dominant profile of an investor falls under the Investor Trust model, the analysis turns to the main theories of how policymakers design protections for the investor.

Part III. Theory of Investor Protection in Financial Markets

Legal systems have adopted four generic approaches to protection of investors in financial markets: (1) information disclosure, (2) direct regulation of institutions, firms, brokers, and organised exchanges operating the markets, (3) prevention of fraud, and (4) the law of private contact, (5) investor insurance schemes, and (6) sanctions for violations and enforcement.42 The economic rationale for investor protection is to induce investors to take risks. Markowitz in his revolutionary discovery of “modern portfolio theory” predicated his theory upon the natural

41 Stout L.A., supra n 27 at 419, citing a series of articles set forth in n. 32.
42 Nr. 6 is discussed infra at “The Importance of Intensity of Enforcement Activity”.
tendency of investors to avoid risk. A risk-averse investor will place savings in low risk instruments, such as fixed income securities, or zero risk instruments such as highly rated sovereign debt securities, rather than engage in investments carrying higher expected returns. To induce investors to take risks and invest in equity requires the alternative of receiving greater economic reward under conditions of controlled levels of risk. Legal systems track this finance theory by enacting rules to promote investor confidence in financial markets.

a. Asymmetric Information

The primary method of retail investor protection is information disclosure. Law has focused upon correcting information asymmetries upon the assumption, that informed investors are protected investors. In the abstract, this thesis is appealing. In practice, the assumption is dubious. For example, providing a retail investor with a prospectus upon which to base a decision to invest is likely ineffective, due to the fact that a prospectus requires skills to read and often a retail investor cannot read financial statements or perform the necessary calculus to produce a range of financial ratios to compare different investment products. The retail investor then is left to rely upon professional advice or make conservative investments that may not be in the best long run interest of the investor. In short, “information asymmetry refers to the client’s limited knowledge vis-à-vis the intermediary with regard to the investment activity [parenthetical information omitted], the information surrounding the investment product in which the client may be interested [parenthetical information omitted], and the intermediary’s self-interest in the client’s activity”. 44

Proceeding form the abstract to the concrete demonstrates the faulty assumption that “disclosure” corrects “information asymmetry” in financial markets. Take one equity and one debt example to make this point. Assume a decision to purchase IBM common stock is subject to fundamental analysis based upon “Graham” criteria. The likelihood of an investor, even supplied with the information, having the ability to

43 Elton E.J., Grauher M.J., Brown S.J., Goetzmann W.N., Modern Portfolio Theory and Investment Analysis (7th ed. John Wiley & Sons, Inc. 2007), stating “The assumption of risk aversion means an investor will reject a fair gamble because the disutility of the loss is greater than the utility of an equivalent gain”. P 247

44 Chiu I., n 26 at 309.
compute the ratios necessary to follow the criteria is rare, if not, non-existent.\(^{45}\) The answer: IBM fails to meet the Graham criterion. However, if we look at Price to Assets, the conclusion may differ. The total assets are 120,432,000 [in thousands] and the price is 120.47 demonstrating a moderate price in relation to total assets, and therefore producing a different conclusion: buy IBM shares. Debt poses equally difficult problems, whether the investor is interested in the debt of a single corporate issuer or a diversified portfolio of different issuers, as the following simple example illustrates.

The price of bonds is inversely related to interest rates, the latter term being equally beyond the comprehension of the retail investor in its construction. In any event it is essential, when comparing bond prices to know the annual return, as displayed by the following table.

<table>
<thead>
<tr>
<th>Bond</th>
<th>Par Value</th>
<th>Coupon Interest Rate</th>
<th>Time to Maturity</th>
<th>Required Return</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$1,000</td>
<td>14%</td>
<td>20 years</td>
<td>12%</td>
<td>$1,149.46</td>
</tr>
<tr>
<td>B</td>
<td>$1,000</td>
<td>8%</td>
<td>16</td>
<td>8%</td>
<td>$1,000.02</td>
</tr>
<tr>
<td>C</td>
<td>$100</td>
<td>10%</td>
<td>8</td>
<td>13%</td>
<td>$85.61</td>
</tr>
<tr>
<td>D</td>
<td>$500</td>
<td>16%</td>
<td>13</td>
<td>18%</td>
<td>$450.95</td>
</tr>
<tr>
<td>E</td>
<td>$1000</td>
<td>12%</td>
<td>10</td>
<td>10%</td>
<td>$1,122.90</td>
</tr>
</tbody>
</table>

These values were derived using standard bond mathematics based on the following formula: \(B_0 = \frac{c}{(1+i)^n} + \frac{M}{(1+i)^n}\) where \(c = \) annual return based on coupon rate, \([i] = \) required rate of return, \(n = \) number of years and \(M = \) par value at maturity. The question presented: is it realistic to expect investors, fully armed with information, to perform the type of equity and/or debt analysis required to make informed decisions in the marketplace regarding which debt instrument among thousands to purchase. The answer is an unequivocal: no. Therefore, parity of information is an illusion.\(^{46}\)

\(^{45}\) Graham B., *The Intelligent Investor* (W.W. Norton & Co., Inc. 9th ed. 1949). The Graham analysis contains the following criteria: (1) Sufficient size, (2) Strong financial condition, (3) Earnings stability, (4) Dividend record, (5) Earnings growth, (6) Moderate P/E ratio, and (7) Moderate Price to Assets Ratio. Applying the Graham criteria to IBM yields a negative correlation between the company’s fundamentals and Graham’s criteria. Therefore, the recommendation would be “not buy.” Regardless of whether the recommendation is correct, as it is probably not, the fact remains that a retail investor is not in a position to evaluate one stock never mind alternative purchases. Appendix B contains a work out of the Graham criteria to IBM.

\(^{46}\) While it is true that “A critical barrier stands between issuers of common shares and public investors is asymmetric information”, most legal scholars do not dig deeper than this self-evident statement. As demonstrated, information parity is probably unattainable and should not constitute the primary

In spite of this conclusion, virtually all jurisdictions require the provision of a prospectus prior to the issuance of securities to the public. The United States arguably pioneered the extensive disclosure requirements of prospectus documents. The European Union is no exception, progressively enlarging the required scope of information to be contained in a prospectus. In addition, though a *bona fide* prospectus satisfies listing requirements, an exchange may require additional information.

b. Direct Regulation of Markets

The second component of law’s response to financial markets is legal regulation of organised changes, investment firms [including banks], licensing of broker/dealers, and designation of a Financial Regulator to monitor market activity and enforce the legal scheme. Types, level, and degree of regulation take many forms throughout the world.

“The most thorough recent survey concludes that, around the world, there are three basic models of securities regulation: (1) a “Government-led model” under which the central government retains significant authority over securities market regulation typified by France, Germany, and Japan); (2) a “Flexibility Model,” which grants

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47 Professor Black places a slightly different spin on resolving the problem of asymmetrical information. He states, 

“Some counties, including the United States, have partially solved this information asymmetry problem through a complex set of laws and private and public institutions that gives investors reasonable assurance that the issuer is being (mostly) truthful. Among the most important institutions are reputational intermediaries – accounting firms, investment banking firms, law firms, and stock exchanges. These intermediaries can credibly vouch for the quality of particular securities because they are repeat players who will suffer a reputational loss, if they let a company falsify or unduly exaggerate its prospects, that exceeds their one time gain from permitting the exaggeration. The intermediaries’ backbones are stiffened by liability to investors if they endorse faulty disclosure, and by possible government or criminal prosecution of they do so intentionally”.

Three key factors are introduced to support reliance upon the value of “reputation”: (1) an influential financial regulator, (2) a strong judicial system, and (3) procedural rules to permit private enforcement actions.

greater authority to the market participants to determine basic policies, but relies upon public agencies to set general policies and maintain some level of enforcement capacity (exemplified by the United Kingdom, Hong, and Australia); and (3) a “Cooperation Model,” which assigns a broad range of powers to market participants with respect to most aspects of policymaking, but also creates parallel and overlapping public oversight bodies with strong enforcement authority (the United States and Canada are the leading examples of this model...[T]he more important point is that all the civil law jurisdictions with major securities markets fall into the first category.” 49

In spite of these differences, the worlds’ markets exhibit several common traits that form generic criteria for the purported purpose of building strong securities markets. Hence, it is worthwhile to review critical institutions and regulatory activity the literature deems necessary to develop a strong securities market.

The empirical work of La Porta, Lopez-de-Silanes and Schleifer in their article “What Works in Securities Laws?” supports this conclusion. 50 The authors examined the securities laws of 49 countries to establish whether there was an empirical link between law and efficient markets, and if yes, the identification of the primary legal rules. While law’s efficacy in markets is still open to debate, their work provides evidence that legal systems use generic building blocks in the construction of their financial markets. The origin of the legal system does not significantly differ in textual legal content; rather, the differences in weight and flexibility of legal rules constituted the statistically significant variations between common and civil law countries.

The authors concluded that, “law matters” for the operation of an effective market. A principal hypothesis was that securities laws reduce the cost of contracting and resolving disputes and therefore encourages firms to raise equity in the capital

49 Coffee J.C., Jr., n 9 at 256.

markets. They found that four key elements: (1) disclosure of material information, (2) effective and low-cost liability remedies for breaches of required conduct, (3) an effective market Supervisor, and (4) investor protection through corporate law. Specifically, they found significant correlation between low burdens of proof for aggrieved investors seeking recovery, developed an index of “Supervisor attributes” arguing for broad powers, and significant relationship between reliance upon criminal and civil law as measures of investor protection. The four “families” of legal systems studied: English common law, French civil law, German civil law and Scandinavian law, while exhibiting common traits, produced differences in market significance in two primary areas: disclosure and enforcement. The common law countries that characteristically adopt these measures had the most significant financial market development as measured by numerous ratios employed by the authors.

By contrast, Professor Choi, subsequent to a detailed review of a plethora of statistical studies investigating whether there is a correlation between law and strong securities markets, concludes “In summary, while statistical evidence provides support for the view that common-law regimes may lead to a more conducive environment for capital markets and ultimately economic growth, anecdotal and historical evidence provides some reason to doubt this relationship. The causality between the legal environment and capital markets may in fact run both ways, and development within a particular country may embody several successive “generations” of legal developments and capital market growth”. While Professor Choi does not deny the “law matters” hypothesis, his critical review of extant studies casts enough doubt to revisit their conclusions.

c. Insider Trading and Market Manipulation

Most legal systems contain rules prohibiting insider trading and market manipulation to bolster investor confidence in the marketplace for financial instruments. These prohibitions, while arguably of insignificant economic value, are deemed essential to provide a level playing field for investors. Take the United States and European

51 La Porta R., Lopez-de-Silanes F., and Shleifer A., n 50 at 7.
52 Stephen C. Choi, n. 12, p. 13.
Union legislation as exemplars of different approaches. “Section 10(b) of the Securities Exchange Act of 1934 prohibits the use of any ‘manipulative or deceptive device’ in the purchase or sale of any security and authorizes the SEC to promulgate rules to protect investors”. 53 Rule 10(b)(5) prohibits, “Any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of a security”. 54 Insider trading jurisprudence, due to the parsimonious language of Rule 10(b)(5) that does not explicitly prohibit inside trading, primarily has developed ad hoc through opinions of the United States Supreme Court, SEC rule making, and lower court opinions. While this ad hoc approach introduces dissonance into the coherence of theory, enforcement intensity of SEC has established the United States as the premier legal regime for punishing wrongdoers.

While insider trading law remained dormant for approximately 40 years, the United States Supreme Court set the base theory in the seminal case of In Re Cady, Roberts & Co., 40 S.E.C. 907 (1961) as further developed in Dirks v. S.E.C., 463 U.S. 646 (1983) and Chiarella v. U.S., 445 U.S. 222 (1980). 55 In SEC v. Texas Sulphur Co, 401 F.2d 833 (2nd Cir. 1968), the Court of Appeals for the Second Circuit commented that a rationale for prohibiting insider trading was to “eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office”. 56 “Insider trading rules” purportedly instil investor confidence by creating the perception that the evaluation of investment risks, and therefore profit making, is equal for all market participants. The decisions adopted a “disclose or refrain” from trading rule. Subsequently, in response to adverse decisions the federal government suffered in Chiarella and Dirks, the SEC promulgated Rule 14e-3 to prohibit any person from trading in target company securities based on non-public information. In

54 17 C.F.R. § 240.10b-5 (2006); see also 17 C.F.R. § 240.10b5-1 (2006) (defining “manipulative and deceptive devices” and “on the basis of” material nonpublic information for purposes of Rule 10b-5 insider trading actions, and identifying affirmative defences).
56 The Texas Sulphur decision notes in footnote 9 to the opinion that insiders cannot unfairly profit from the privileges of their office.
addition, the United States Supreme Court in *US v. O’Hagan*, 521 U.S. 642 (1997) adopted the so-called “misappropriation” theory providing that persons in possession of inside information that lack traditional fiduciary obligations commit fraud if they trade on that information in breach of a duty owed to the source of that information.


> “Inside information shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more issuers of financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments”.

The Recitals explain the rational and objectives of the Directive. Consistent with generally accepted theory, Recital 2 states, “An integrated and efficient financial market requires market integrity. The smooth functioning of securities markets and public confidence in markets are prerequisites for economic growth and wealth. Market abuse harms the integrity of financial markets and public confidence in securities and derivatives.” Recital 15 further provides, “Insider dealing and market manipulation prevent full and proper market transparency, which is a prerequisite for trading for all economic actors in integrated financial markets”. In addition, the Directive seeks to establish a “level playing field in Community financial markets”.

The two exemplars show that each jurisdiction unequivocally assume that the law must prohibit insider trading to promote investor confidence in the financial markets and to deepen the liquidity of the markets through greater retail activity. Without


58 Directives subsequently issued further refine the implementation of Directive 2003/6/EC.
questioning the validity of the assumption, rules that prohibit insider trading are a necessary, but not sufficient, pillar upon which to build a securities market.59

d. Private Contract

The law of private contract enters the realm of investor protection since to open a securities account requires the retail customer to execute a contract with a broker. That contract invariably is a standard form contract that contains numerous terms not subject to bargain. While MiFID and other law mandate the disclosure of certain terms, the contract nevertheless falls within the purview of specialised legislation such as the Unfair Consumer Terms Directive to determine the validity of any particular term.60 United States jurisprudence deems account holder contracts as “contracts of adhesion” whose provisions are subject to heightened scrutiny given the absence of bargain and negotiation of terms. Standardised contracting in the investment sphere does not differ in any respect from standardised contracting in sales of goods. Legal issues such as inequality of bargaining power, consent, damage limitations and enforcement of terms are likely to result in dispute thereby implicating relevant contract and consumer protection law.

e. Investor Protection Insurance

The Securities Investor Protection Act of 1970 provides retail investors with protection against losses incurred in the event of a brokerage firm failure, missing securities, or theft.61 SIPIC is not equivalent to the FDIC that insures bank deposits up to $100,000 per account. SIPIC does not protect the investor against market losses since rewards are only possible through the assumption of risk. Rather, SIPIC replaces stocks and other securities under certain conditions even when the investments have increased in value. Nevertheless, SIPIC’s coverage does not extend to commodity futures contracts and currency, as well as investments in limited partnerships.


The European Union equivalent is Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes. The minimum coverage is EUR 20,000, with a 10% deductible, providing insurance up to EUR 18,000. Like SIPIC, the Directive applies to designated investment instruments [originally identified in the now repealed Investment Services Directive]. Membership in an investor compensation scheme is mandatory. However, since the Directive is a minimum harmonisation Directive and levels of coverage differ among Member States, the scheme of the Home State of the investment firm generally applies to that firm’s customers.

Part IV. Critical Assessment: Role of Investor Protection in Macroeconomic Function of “Financial Markets”

a. The Myth of Symmetrical Information

“Seventy years ago the Securities and Exchange Commission (SEC) was created to serve investors.” The Securities Act of 1933 and the Securities Exchange Act of 1934 were New Deal statutes that addressed the perceived causes of the 1929 Stock Market crash. These causes were stock market manipulation, insider trading, and breaches of fiduciary duties by public corporations and their intermediaries. The development of investor protection for retail customers addressed foremost the different level of information between corporate insiders, investment professionals, and the retail customer based on classical economic theory and contract law.

One of the theoretical presuppositions of market economies is relatively perfect competition in the market, including perfect dissemination of knowledge. Consumer protection legislation arose to correct inherent imperfections in the market caused by, for instance, consumers’ inability to wield perfect knowledge or equal bargaining power in standardised commercial transactions. While consumer protection legislation cuts against classical contract theory by limiting the parties’ freedom of contract, governmental regulation of the market is in fact rather modest because most consumer protection statutes merely regulate extreme forms of commercial misconduct and provide the consumer with information that theoretically restores the market to its

63 Karmel R.S., n 62 at 910.
ideal state. Analogical argument leads to the same conclusions for disclosure of market information to retail investors.

The European Union has followed a similar, if not identical approach. Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on the information to be published on those securities, as amended by Directive 2004/109/EC using the term “regulated market”, requires issuers to disclose specifically identified information to investors prior to making a public offer, and subsequently to produce a continuous stream of information deemed material to investment decision.

Disclosures of information about securities and about the corporations or entities that issue them fail to protect the investor. With certain exceptions, information, in and of itself, is meaningless. The overwhelming majority of retail investors lack the skills necessary to interpret the information, compare that interpretation to alternative investments, to make informed decisions about purchasing securities. This point has been made dead certain by the prior two illustrations involving the “fundamental analysis” techniques to IBM equity and involving simplistic bond mathematics to determine annual yield. In addition, if a retail investor were to build a small portfolio of securities, say ten different instruments, the amount of information the law would require to be disclosed would overwhelm the retail investor. Finally, if one endorses the Efficient Capital Market Hypothesis, reading through the data is a waste of time, since prices already reflect all material information available to the entire market.

Further support for the ineffectiveness of this method of investor protection is the time delay between the emergence of the “evil” in the market and the enactment of the law to correct the “evil”. Regulation FD (Fair Disclosure) is an apt example. That regulation requires issuers to disclose to the public information they give to professional analysts during periodic interviews. The practice of analysts holding conferences with corporate representatives, often the CEO, to acquire information about the issuer was a standard practice of the industry. The SEC did not issue Regulation FD until year 2000. This delayed reaction is like “closing the barn door

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65 Bodie Z., Kane A., Marcus A., Investments (5th ed. McGraw Hill 2002) p 341 (stating “the notion that stocks already reflect all available information is referred to as the efficient market hypothesis (EMH)). The EMH comes in three forms: (1) weak form, (2) semi-strong, and (3) strong-form. Pp 342-343. The latter provides the price reflects all information.
after the horse has bolted”. Elis Ferran makes a related observation about the development of EU law in the financial services area:

“The Lamfalussy process was applied to many of the new EU laws that are considered in this book. However, those laws were first formally proposed in the FSAP, an initiative which preceded the adoption of the new legislative process. This sequence of events deserves emphasis. Whilst it is legitimate to ask whether the adoption of the Lamfalussy process has helped produce better-quality laws governing securities market activity within the EU, it is also important to bear in mind that the Lamfalussy process came late, after certain important strategic policy decisions had been made and, crucially, after the timetable for the adoption of the FSAP had been set. These considerations must qualify whatever blame for the substantive quality of the recent laws is laid at the feet of the legislative process."

Although it is difficult to compare the US and EU legislation, given the differences in historical development and the relatively recent action of the Community in the forum of financial markets, nevertheless the two different jurisdictions have adopted an approach to investor protection that does not accord with the reality of the retail investor. Admittedly, corporations that list and sell stock to the public must be subject to penalties for legal violations. However, it is difficult to assess how well disclosure laws defeat the conduct it is designed to prohibit.

b. The Importance of Intensity of Enforcement Activity

Professor Coffee conducted a study on the “comparative research on enforcement”, relying upon the preceding work of Professor Howell Jackson of Harvard Law School, constructing an empirical model to measure the “intensity” of enforcement among different jurisdictions. Without repeating the complex analysis undertaken by Professor Coffee, his comparative analysis between the United States and the United Kingdom are illustrative either of different styles or of inadequate enforcement supervision by the United Kingdom. Coffee first acknowledged that “insider trading” is common in the United States and the United Kingdom. However, the public enforcement response is radically different. “Between 2001 and the fall of 2006, the SEC brought just over 300 insider trading enforcement actions against over 600

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66 Ferran E., n 17 at 6.
67 E.g., Pikoulas v. Kefalaiagoras, (2007) Case C-430/05 where the First Chamber upheld penalties imposed by the Greek Capital Market Commission because the company Donik AE whose shares were already trading on the stock exchange filed a listings particulars requesting an increase in authorised stock that had serious discrepancies in its profit and loss statements.
68 Coffee J.C., Jr., n 9 at 280.
individuals and entities. In addition, as the following table illustrates, the U.S. Department of Justice criminally prosecutes insider trading.

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Pending Cases</th>
<th>Indictments</th>
<th>Convictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>56</td>
<td>24</td>
<td>15</td>
</tr>
<tr>
<td>2005</td>
<td>67</td>
<td>19</td>
<td>19</td>
</tr>
<tr>
<td>2004</td>
<td>53</td>
<td>21</td>
<td>13</td>
</tr>
<tr>
<td>2003</td>
<td>51</td>
<td>14</td>
<td>15</td>
</tr>
<tr>
<td>2002</td>
<td>52</td>
<td>16</td>
<td>12</td>
</tr>
<tr>
<td>2001</td>
<td>53</td>
<td>16</td>
<td>14</td>
</tr>
</tbody>
</table>

By contrast, “criminal prosecutions of insider trading are conspicuous by their absence in the United Kingdom. Even civil actions are rare”. Between 2001 and 2007, the FSA brought eight cases of insider trading to successful conclusion. Importantly, the FSA’s own staff economists reported an increase in insider trading during 2004-06 and attributed that increase to lack of law enforcement. In addition, compared to the United States, the fines are miniscule averaging 50,000 USD. By comparison, the chief executive officer of Qwest was sentenced to six years’ imprisonment, fined 19 million USD and required to forfeit 52 million USD.

After finding that the SEC spends approximately 37.9% to 41.0% of its annual budget on enforcement activity, Professor Coffee turned his attention BaFin, the German Financial Regulator. The following table summarises the relevant data for BaFin.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Budget (E MM)</th>
<th>Spent on Enforcement</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>109.71</td>
<td>3.40</td>
<td>3.1%</td>
</tr>
<tr>
<td>2006</td>
<td>126.82</td>
<td>6.51</td>
<td>5.1%</td>
</tr>
<tr>
<td>2007</td>
<td>120.15</td>
<td>7.81</td>
<td>6.5%</td>
</tr>
</tbody>
</table>

Coffee concluded that “FSA and BaFin seem to share a common aversion to enforcement”.\(^{69}\) This finding has two implications relevant to the object of this brief: (1) MiFID seeks to increase dispersed ownership of companies, and (2) the EU prides itself on the integrity of its company law and financial markets. However, if MiFID achieves its objectives by increasing ownership dispersion, then investors are either left without a remedy due to enforcement style or the lack of enforcement will chill

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\(^{69}\) Noteworthy is the fact that in 2008, 28% of mergers in the United Kingdom were preceded by suspicious stock trading, including possible insider trades, as acknowledged by the FSA. Wall Street Journal, *In U.K., 28% of Mergers Raise Alarms*, C1 (April 30, 2008).
retail investment in the market. An inherent contradiction pervades EU policy makers and public enforcement officers. European companies eschew the US public markets due to compliance costs that would confer direct benefits upon their shareholders and provide the companies with direct benefit of cheaper capital, and a valuation premium or cross-listing their shares. Simultaneously, the EU seeks to emulate the US markets but appears to lack the stomach to intensify its enforcement against corporate fraud.

c. Access to Justice

The United States is an outlier in the sense of permitting private enforcement of violations of securities laws principally, but not exclusively, through class action lawsuits. While not entirely unknown in the European Union, the class action lawsuit, in conjunction with contingent legal fees, plays a significant role in evaluating the full magnitude of enforcement disparity between the United States and European Union. Private monetary sanctions far exceed public monetary sanctions as illustrated by figures based statistics from 2000-2002.

<table>
<thead>
<tr>
<th>Public Monetary Sanctions</th>
<th>Private Monetary Sanctions</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Monetary Sanctions: $931,212,489</td>
<td>Class Action Trial Awards: $17,626,000</td>
</tr>
<tr>
<td>NASD Disciplinary Sanctions: $126,110,622</td>
<td>NASD Arbitration Awards: $104,000,000</td>
</tr>
</tbody>
</table>

The virtues of class action lawsuits are debatable. In many instances, the largest portion of settlements or judgments are awarded as attorney fees, providing trivial compensation to investors. However, the threat of these suits act as a deterrent. The permission to contract legal services by contingency fee arrangements gives small investors access to the courts that they otherwise would be denied. In addition, the general rule of the United States that each party bears its costs, does not have the chilling effect upon bringing an action against a large corporation, bank or investment firm. A loser pay rule, as is common in the European Union, virtually closes the door on retail investors to pursue remedies in court.

Ironically, the European hysteria, following the decision in Centros, resulting in accusations that Europe will suffer from the Delaware effect, or race to the regulatory bottom, has not found a similar response to its dubious deference toward the interests of private majority shareholders.
Part V. Comparative Analysis of Select EU and US Investor Principles Law

MiFID, consistent with conventional macroeconomic theory, seeks to unlock the savings accounts of retail investors and transfer them onto the financial markets. In other words to take assets stored in a relatively safe haven, though admittedly producing limited returns, and place them potentially, though perhaps unlikely, at 100% risk of loss. The savings accounts of the private sector in Europe amount to approximately 20% of GDP. Unlocking that treasure trove constitutes a substantial stimulus for the creation of an active financial market. This fundamental rationale of MiFID explains the extended scope of investor protection provisions contained in the Directive. However, the style of investor protection taken in the Directive is as likely to raise transaction costs and enrich investment firms as much as it may shield investors from risk. MiFID represents a paradigm shift in the EU process of building a securities market.

Capital markets and securities exchanges have undergone substantial changes in the last thirty years. Consolidated national exchanges have yielded to fragmentation, the rise of alternative trading systems, diversity of product, and the increasing participation of retail investors in the financial markets. Competition-driven innovation in the markets has brought benefits in terms of reduced transactions costs as the national exchanges have lost monopolistic control. The Investment Services Directive failed to envision these developments and served to impede rather than track or support market developments.

Concurrently, this innovation and architectural restructuring of the financial markets has raised novel questions for legal systems, and MiFID raises clusters of issues. While it is beyond the scope of this brief to address developments on this scale, the following issues are addressed in this section: (1) best execution, (2) transparency, (3) access [linkages], drawing comparisons between the United States and the European Union. “With more market centres than ever before, transparency and linkages have become even more critical to providing those who act on behalf of investors the opportunity and tools to effectively serve their customers”.71 “Client Classification” under MFID is addressed in the following section.

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a. Factual Landscapes

The factual landscapes of the “financial markets” in the United States and the European Union are necessary to describe to understand parallel legal developments and to avoid getting mired in highly technical jargon in assessment of the rules within each jurisdiction. Since the United States experience preceded that of the European Union it is the logical starting point.

“In 1975, after active and far reaching hearings on the nation’s securities markets, Congress adopted significant amendments to the Securities and Exchange act of 1934.”\(^72\) Congress mandated the SEC to create a “national market system” for the trading of securities, to respond to structural changes in the financial markets, and to rectify market failures. The concept of the “NMS” parallels the ambition of MiFID to create a single internal market in financial services. The SEC relies upon its mandate under NMS to promulgate rules to achieve its objectives. NMS encompasses the stocks of more than 5000 listed companies collectively representing more than $14 trillion in U.S. market capitalisation.\(^73\)

Factually, there are ten registered securities exchanges in the United States, and nine of the ten have adopted new equity trading systems. Most notably, the New York stock Exchange (NYSE), the largest equity market in the world, has fully automated its quote for the first time in its history”.\(^74\) All exchanges have brought new trading systems into operation as of March 5, 2007. In addition to the ten registered exchanges, a variety of alternative trading systems (ATS) compete for trading volume in the United States. The NYSE has merged with the fully automated Archipelago Exchange, originally an electronic communication network [ECN], and the NYSE merged with “Euronext”.\(^75\) NASDAQ, an approved exchange, has merged with two competitor ECNs, and has integrated the respective three trading systems into a single


\(^{75}\) “NYSE Euronext, the holding company created by the combination of NYSE Group, Inc. and Euronext N.V., was launched on April 4, 2007. NYSE Euronext (NYSE/New York and Euronext/Paris: NYX) operates the world’s largest and most liquid exchange group and offers the most diverse array of financial products and services. NYSE Euronext, which brings together six cash equities exchanges in five countries and six derivatives exchanges, is a world leader for listings, trading in cash equities, equity and interest rate derivatives, bonds and the distribution of market data.” Overview taken from http://www.nyse.com/about/1088808971270.html viewed 22 December 2008.
system. In addition, NASDAQ acquired OMX Group, now is called NASDAQ OMX. Three electronic communication networks publicly display their quotes through the National Association of Securities Dealers’ Alternative Display Facility, and a large number of other ATSs operate “dark” pools of liquidity. “These dark ATSs include crossing systems that facilitate block trading by institutional investors, as well as liquidity pools operated by broker-dealers that seek to match orders internally prior to any interaction with the transparent, public markets”. 76 Consequently, the NMS is a composite of multiple structures and systems presenting on a larger scale, though with substantial differences, the outlines of the European landscape in securities.

The European Union had 15 National stock exchanges and several regional exchanges, more than 20 derivatives markets, no centre for bond trading, 23 securities settlement systems, and 13 retail payment systems. 77 Since monetary union, the “number of post-trading organisations and exchanges has decreased”, but the EU is far from having a consolidated Pan-European market in securities with substantial cross-border trading. The current landscape is represented as follows:

A key to the symbols used in this diagram is also available. Click here for the key, which you might wish to print before studying this complex diagram.

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76 Gray D. M., n 74 at 399.
The chart demonstrates that there are four active areas in the European Union securities market: the London Stock Exchange, NYSE Euronext, Deutsche Borse, and OMX [renamed NASDAQ OMX]. It also identifies the major clearing centres: Euroclear and Clearstream, and the markets where derivative products are traded. The following chart shows third-party ownership of the exchanges and clearing systems. Noteworthy is the ownership of VIRT-X by Switzerland. Although the markets are fragmented, raising identical problems found in the United States, and raising similar issues of investor protection, it calls into question to what extent this framework can be called “European” and not international.
The various centres are not integrated, exhibit extremely different characteristics, and mainly have a domestic focus. For example, the Deutsche Borse AG operates the Frankfurt Exchange (FX), the largest of the German exchanges. FX uses an electronic trading platform called XETRA on which most of its shares are traded. However, approximately 30% of trades are executed off the exchange, the results being reported to BAFin. In addition, Germany has seven regional exchanges that compete with the Frankfurt Exchange, but none of the exchanges are linked to share data and permit multi-exchange access. German law does not even require that an order be sent to an exchange offering the best price. The Dusseldorf Stock Exchange has 40% ownership stake in Quotrix AG that operates two ECNs. Take the London Stock Exchange as a second example. The LSE operates an electronic book order system know as SETS. It also operates a second tier market – AIM – that is a sub-sector of the national exchange. To promote cross-border trading, in 2004 the LSE launched the Dutch Trading Service allowing LSE clients the option to trade Dutch securities on the

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Ryan J. Davies, n. 6, pp 17-19 explains extensively the various markets depicted in the above figure.
SETS order book. In addition, internalisation is widespread in the United Kingdom. The larger retail brokerage houses, operate Retail Service Providers to which they route client orders that are matched against corresponding orders. The post-trade transaction is reported to the exchange. Other markets such as Spain and Italy exhibit a central market mentality relying upon the concentration principle found in the Investment Services Directive.

Having established a factual background, the US experience in the areas of “best execution”, “transparency”, and “linkages” are examined and then appropriate comparisons to the MIFID approach is identified.

b. Best Execution: US Rules

The first problem is to define the term “best execution”. “The SEC has explained that a broker has ‘a duty to seek to obtain the best execution for customer orders, which is understood to mean that a broker-dealer must obtain the most favourable terms available under the circumstances for a customer’s transaction’”.

Scholars considered this standard amorphous, though the SEC provided a list of non-exhaustive factors for consideration. Price was not necessarily deemed the sole factor. Other elements informing the choice are: characteristics of the security, favourable market, availability of technology, and size of the order. Court decisions enforce the duty but have failed to provide more precision to the broker’s obligation.

Best execution is simply the duty of an agent to act in the best interests of its client.

The SEC in Rule 611 of Regulation NMS specified one aspect of the broker’s duty by forbidding executions based on “trade through”, that is, an order not executed at the best possible price given quoted prices at other exchanges. Subject to some exceptions, an investor must receive the price equivalent to the price quoted on any other trading centre. Rule 611 is known as the “order protection rule”. The order protection rule requires that each exchange establish and enforce policies to ensure

80 E.g., Newton v. Merrill Lynch, 135 F.3d 266 (3rd Cir.), cert. denied, 525 U.S. 811 (1998) (finding that broker filled all orders at NBBO price breached the duty of best execution)
consistent price quotation for all NMS stocks, which include those on the major stock exchanges as well as many over-the-counter (OTC) stocks.81

Nevertheless, Rule 611 does not alter or diminish the duty of best execution. Regulation NMS provides:

“A broker-dealer has a legal duty to seek to obtain best execution of customer orders. According to the Report of the Special Study of Securities Markets, “[t]he integrity of the industry can be maintained only if the fundamental principle that a customer should at all times get the best available price which can reasonably be obtained for him is followed.” A broker-dealer’s duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated in SRO rules and, through judicial and Commission decisions, the antifraud provisions of the federal securities laws. The duty of best execution requires broker-dealers to execute customers’ trades at the most favorable terms reasonably available under the circumstances, i.e., at the best reasonably available price.

The Commission has not viewed the duty of best execution as inconsistent with the automated routing of orders or requiring automated routing on an order-by-order basis to the market with the best-quoted price at the time. Rather, the duty of best execution requires broker-dealers to periodically assess the quality of competing markets to assure that order flow is directed to the markets providing the most beneficial terms for their customer orders. Broker-dealers must examine their procedures for seeking to obtain best execution in light of market and technology changes and modify those practices if necessary to enable their customers to obtain the best reasonably available prices. In doing so, broker-dealers must take into account price improvement opportunities, and whether different markets may be more suitable for different types of orders or particular securities.

The protection against trade-throughs required of trading centers by Rule 611 undergirds the broker-dealer’s duty of best execution, by helping ensure that customer orders are not executed at prices inferior to the best protected quotations. Nonetheless, the Order Protection Rule does not supplant or diminish the broker-dealer’s responsibility for achieving best execution, including its duty to evaluate the execution quality of markets to which it routes customer orders, regardless of the exceptions set forth in the Rule. 82

81 Rule 611a provides, “A trading centre shall establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs on that trading centre of protected quotations in NMS stocks that do not fall within an exception set forth in paragraph (b) of this section and, if relying on such an exception, that are reasonably designed to assure compliance with the terms of the exception.”

82 Regulation NMS n 67 at 159-61.
The duty of best execution and the “order protection rule” are effectuated based on the structure of the NMS. In 1971, the SEC instituted the Intermarket Trading System Plan that is a market to market routing system enabling orders to be transferred from one market to another to determine which market is offering the best price. The ITS plan links over-the-counter dealers with all securities exchanges. The Regulation also provides for the development of private linkages to enhance intermarket communication. In addition, various reporting systems provide virtually instantaneously securities transaction data, for example, the Consolidated Tape, various systems run by NASDAQ, and the Consolidated Quotation System also operated by NASDAQ. Regulation NMS also contains a “new access rule” to promote “fair and non-discriminatory access to quotations displayed by NMS trading centres through a private linkage approach”.

c. Best Execution Rules: MiFID

Article 21 contains the “best execution rule” for MiFID and consists of six lengthy paragraphs. The first paragraph states the basic rule:

“Member States shall require that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction”

Recital 33 adds, “It is necessary to impose an effective ‘best execution’ obligation to ensure that investment firms execute client orders on terms that are most favourable to the client. This obligation should apply to the firm which owes contractual or agency obligations to the client”. The best execution duty is an elaboration of principal-agency rules and the general obligation of due diligence. Retail and professional clients are covered as Article 44 of Directive 2006/73/EC makes clear. In an elaborate analysis of the “best execution rule” and adopting a UK perspective, Paul Nelson correctly observes that the rule applies to all covered instruments. He also provides from a practitioner’s point of view how, under certain circumstances, the rule may be difficult to apply, or may not apply at all if the other party is deemed an Eligible Counterparty.\(^83\) The bottom line is that the “best possible result shall be

\(^{83}\) Nelson P., n 19, pp 391-407.
determined in terms of total consideration”. Application of that standard will vary depending on circumstances and is further complicated by what the Directive calls “internalisation”.

The Directive lacks the punch of an “order protection rule”. Informed observers note:

“A fortiori it would seem that the search for the best reference price is at the core of an internaliser’s obligation to best execution. Taking the principle of best execution seriously, investment firms that internalise customer orders should automatically execute orders at the national best bid or offer [NBBO] irrespective of their own quotations. Indeed they should refer to a European [Euro zone] best bid or offer [that is technically feasible]. However, it is no less clear that MiFID Article 27(1)(3) does not require such best execution proper. The soft obligation to ‘reflect the prevailing market conditions’ neither requires benchmarking, let alone reference to the best available quote.” 84

Under existing circumstances, the obligation to seek out diverse venues to fulfil the best execution duty would not appear to survive a cost/benefit analysis. MiFID acknowledges this burden by providing that firms do not have to be connected to a variety of venues if that comes at a disproportionate cost. However, it is unclear whether “internalisation” is the customer or broker’s gain. In addition, MiFID allows “price improvements” in transactions with professional clients under Article 27(3)(4). “This is rather discrete language for a business practice which expressly allows of price discrimination”. 85 Moreover, the EU consists of 27 Member States, only 16 of which have adopted the EURO, thereby imposing currency transaction fees on cross-border transactions outside the Euro zone. Further, several new Member States are ill equipped to meet the requirements of the Directive. The Directive appears to be predicated upon the infrastructure of financial markets in the few developed money centres of Europe.

b. Transparency: US Rules

In the words of Arthur Levitt, “Even if brokers establish very clearly the investing objectives of their customers, brokers must be able to see the best prices in the market if they are truly to achieve best execution”. 86 Transparency impacts prices particularly through the dissemination of limit orders that indicate the supply and demand for a

84 Kondgen J. and Theissen E., Internalisation under the MIFID: Regulatory Overreaching or Landmark in Investor Protection, in Investor Protection in Europe, n 37 at 271, 289.
85 Kondgen J. and Theissen E., n 84 at 287.
86 Levitt A., n 71 at 515.
security at a particular price. These orders allow investors to become price setters and to shape the prices of securities by the forces of competition.

In 1997, the SEC enacted the Limit Order Display Rule. “It simply stated that dealers holding customer limit orders that are equal to or better than the market price must either execute the orders immediately or display them to the market”.\(^\text{87}\) In the view of Levitt, the Order Handling Rules that include the Limit Order Display Rule have reduced spreads by over thirty percent. A series of other rules, such as Rule 11Ac1-1 requiring dissemination of quotes, Disclosure of Order Execution and Routing Practices, Regulation NMS adoption of “Market Data Rules and Plan Amendments” contribute significantly to market transparency, though deeper transparency is needed. NASDAQ’s SUPERMONTAGE and the NYSE’s Open Order Book are important market steps toward achieving a transparent financial market.

c. Transparency: MiFID Rules

A constellation of Articles within MiFID deal with transparency: Article 27 [Obligation for investment firms to make public firm quotes]; Article 28 [Post-trade disclosure by investment firms]; Article 29 [Pre-trade transparency requirements for MTFs]; Article 30 [Post-trade transparency requirements for MTFs]; Article 44 [Pre-trade transparency requirements for regulated markets]; and Article 45 [Post-trade transparency requirements for regulated markets]. Collectively, these Article impose substantial obligations on markets, investment firms, and MTFs to make public transactions in securities. Recital 44 drives home the point of the importance of transparency “to ensure the effective integration of Member State equity markets, to promote the efficiency of the overall price formation process for equity instruments, and to assist the effective operation of best execution obligations”. This rationale accords seamlessly with the rational underpinning the US NMS and appears to be a statement of the obvious. Investors require pre-trade transparency of prices to determine whether to buy or sell a security. If the investor enters a market order, post-trade transparency is absolutely necessary since the investor never knows the exact price paid \textit{ex ante}.

\(^{87}\) Levitt A., n 71 at 516.
d. Linkages: US Rules

The final crucial component to ensure that investors receive the best possible price is effective linkages between markets. The principal rationale for linking diverse markets is to achieve price equilibrium. An identical security may be trading at different prices on different markets. The question is: why should not the customer get the best available price. For example, “If quote prices are changing rapidly, often the market where the broker routes an order no longer offers the best price by the time that order arrives. Intermarket linkages help ensure that the order still gets the best price at the point of sale.”

The US approach primarily has left the development of linking markets to the private sector, though the SEC is active in promoting tighter connections among markets and relying upon market innovations in technological progress.

e. Linkages: MiFID Rules

MiFID accomplishes the goal of intermarket connections by means of enhancing the ability of investment firms to use the European single passport to conduct business throughout the European Union. This goal is accomplished by increased harmonisation of national supervisory rules, recognition of MTFs as investment firms able to acquire and use the single passport, and a requirement placed upon clearing and settlement facilities to permit access to authorised firms. Equally critical to financial market integration is the adoption of the “concentration rule”, thereby harmonising the laws of the Member States. The cross-border activity of market venues defined broadly as investment firms, regulated markets, “systematic internalisers”, or MTFs is the method used to enhance market liquidity and to create conditions to establish connections among markets to serve investor interests.

f. Client Classification System: MiFID

MiFID recognises three types of clients: (1) professional, (2) retail, and (3) counterparty. The greatest regulatory protections are afforded to retail clients. Ap

88 Levitt A., n 71 at 517.
89 US legislation does not have a counterpart to this methodology of MiFID. Rather, individual investment firms may require prior authorisation to engage in certain investments. For example, Fidelity Investments requires prior authorisation for a retail investor to engage in short sales. Essentially, a licensed broker informs the retail investor of the risks inherent in this strategy, before the
professional client is a person that satisfies the criteria set forth in Annex II of the Directive. A retail client is any person not deemed a professional client. Eligible counterparties are defined by Member States. However, per se eligible counterparties are investment firms, credit institutions, insurance companies, UCITS, pension funds, and governments. The classification scheme triggers the level of protection investment firms are required to provide through the conduct of business rules. Noteworthy is the fact that a client’s classification status is fluid depending upon the nature of the transaction and the partitioning scheme found in the Directive.

Annex II defines a professional client as “a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs.” Section I then defines by default clients deemed to be professional clients. This partitioning covers mainly institutional investors that do not need consumer level protection. However, Annex II provides for two exceptions: (1) opt-down and (2) opt-up. A client defined as a professional client by default may request to be treated as a retail client for certain transactions and therefore opt-down for greater investor protection. By contrast, a person not falling within the default category of professional client may request to be treated as a professional client. A firm does not automatically honour a request. Rather, Section II of Annex II sets forth the procedure to be followed to permit a person to opt-up to the status of a professional client.

“In particular, the firm may opt a client up only if it has assessed the client’s expertise and knowledge and is satisfied that the client is capable of making its own investment decisions and understanding the risks involved regarding the types of transactions and services envisaged. During this assessment, the firm must be satisfied that at least two of the following criteria are satisfied”\textsuperscript{90}:

1. The client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters, or
2. The size of the client’s financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500,000, or
3. The client works or has worked in the financial sector for at least one year in a

account holder is allowed to conduct operations in his/her portfolio. The additional risk warnings are designed to protect the firm against subsequent lawsuits based on investor losses.

\textsuperscript{90} Freshfields Bruckhaus Deringer, \textit{MiFID: Customer Classification, Suitability and Appropriateness}, Briefing April 2006.
professional position, which requires knowledge of the transactions or services envisaged.\footnote{Annex II.1 of the Directive.}

If the client is neither a professional client nor counterparty, then the client is considered a retail client subject to suitability and appropriateness requirements. The Level 2 Directive provides in detail the requirements a firm must follow to meet its investor protection obligations to a retail client. Article 19(6) contains an important exception for retail clients that seek to execute trades in non-sophisticated instruments on regulated markets.\footnote{E.g., In the United States, an $8 commission for a retail trade is commonplace. At current exchange rates, that commission equals about 5 EUR. Intuitively, equivalent fees for trades in Europe appear unlikely.} The firm is relieved of the “assessment” requirement set forth in Article 19(5). This rule is the equivalent of permitting a retail customer to open an account at an investment firm, such as Fidelity Investments or E-Trade, and manage, within the limitations established by the Directive, his or her own portfolio, without the intervention of the firm’s professional advisor. The benefit to the client should be lower transaction costs.

However, the opt-out provision is subject to severe restrictions that demonstrate the paternalistic approach of MiFID. The Level 2 Implementing Directive specifies that all the following conditions must be met before a client is liberated from a “suitability assessment”:

1. The ... services relate to shares admitted to trading on a regulated market or in an equivalent third country market, money market instruments, bonds or securitised debt (excluding those bonds or securitised debt that embed a derivative), UCITS and any other non-complex instrument.... The Commission shall publish a list of those markets that are to be considered as equivalent. This list shall be periodically updated.
2. The service is provided at the initiative of the client or potential client,
3. The client or potential client is has been clearly informed that in the provision of this service the investment firm is not required to assess the suitability of the instrument or service provided or offered and that therefore he does not benefit from the corresponding protection of the relevant conduct of business rules: this warning may be in a standardized format.
There are several drawbacks to this exception. The first is why limit the investor to such a narrow scope of trading activities. The second is why assume that an investor purchasing a UCITS is not as likely to lose “his shirt” as an investor selling a stock short, a trade presumably prohibited under Art. 21(3) of the Level 2 Directive. The third is the electronic restrictions placed on the account to insure enforcement are likely to annoy the investor and give the appearance that the investment firm is a “financial cop”. The fourth is the expense of the additional recordkeeping the exclusion inevitably would require.

Absent the application of Article 19(6), a firm is obligated to undertake an examination of the client to determine the appropriate level of risk, investment objectives, and nature of advice to be provided. Article 35 of the Level 2 Directive provides that the firm must “obtain from clients or potential clients such information as is necessary for the firm to understand the essential facts about the client and to have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided” that a particular transaction related to portfolio management meets three criteria. These are:

1. It meets the investment objectives of the client in question;
2. It is such that the client is able financially to bear any related investment risks consistent with his investment objectives; and
3. It is such that the client has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of his portfolio.

The Level 2 Directive contains additional requirements to obtain information, provide reporting of trades and portfolio performance, and to provide account statements. These requirements typify expensive investment advice. Read literally, the retail investor must get the permission and advice of the professional money manager before making an adjustment to a portfolio of investments, since there is no explicit provision to opt out of the regime.

A review of the market indicates that investment funds, both closed and open-ended funds, constitute a primary activity of banks and certain investment firms.93 For purposes of discussion, Parex Asset Management [PAM], a 100% subsidiary of Parex

Banka, and in its words, a “leading investment management company in the Baltics” is used to identify characteristics of fund operation in the Baltic area, in particular from a retail investment viewpoint, though PAM services both retail and institutional clients. It also is used to demonstrate the faulty assumptions underlying MiFID investor protection. According to its May 2008 Report, PAM “services more than 200 000 clients, high net worth individuals, corporates [sic], and institutional investors”. PAM has 11 funds registered in Latvia, 5 in Lithuania, 3 in Russia, 3 in Ukraine, 4 in Germany, 3 in Switzerland, and 1 in Sweden. The territorial range of funds is broad but mainly capitalises on the Baltic Sea Region, the Russian Federation, the Republic of Ukraine, real estate in Latvia, and funds of funds. PAM has listed the following fund types on NASDAQ OMX: 5 equity funds, 2 balanced, 3 fixed income [bonds], 5 funds of funds and 1 real estate.

Take the Parex Baltic High Yield Fund. In section 2.2, in the table of fees, a notation at the bottom of the table states, “Total Annual Fund management fee shall not exceed 3.0% of the Fund’s average asset value per year”. The fee to the company is 1.5%, to the custodian 0.15% of the Funds Net Asset Value per year [but then adds EUR 6 per transaction fee], 0.10% to the auditor, and then payment to third parties where fees are not specifically denominated. More disturbing is section 2.3 that is entitled “Other payments from the Fund’s Property”. This section states, “Other payments comprise such expenses as transaction charges, broker fees, and interest on loans”. Taken together, the language of the prospectus is obtuse, and difficult to discern the exact fee an investor ultimately will pay the company. The custodian is Parex bank. Is this MiFID compliant or not? Only litigation would resolve the issue.

Given PAM the benefit of the doubt, it can be assumed, despite the language in 2.3, that the fees charged per year to the investor are capped at 3%. But the question arises: what exactly does that mean for the investor? In 2006, the fund opened with a NAV in EUR of 1000. As of May 2008, two years later, the fund had an NAV of

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94 A certain irony attaches to the marketing hype of Parex Banka. In November 2008, the bank failed, due to a run on its deposits, and was purchased by a state owned institution for 2 LVL or approximately SUSD 4. Now nationalised, the Latvian government must commit massive funds to stabilise the bank and then find a buyer for this institution calling its asset management arm: a “leading investment management company in the Baltics”. The example is drawn from Burke J.J.A., “The Baltic Securities Market: Product of Economic Innovation”, forthcoming in the Institut Suisse de Droit Comparé, published by Schulthess Médias Juridiques SA Genève, Zurich, Bâle, in a new volume 63 of our collection (2009) “Publications of the Swiss Institute of Comparative Law”.

1,116.07, an annualised increase of approximately 5%. Given an annual 3% management fee, the investor has paid an average of 30 EUR per year to PAM or 150,000 EUR per year in the aggregate or 300,000 EUR based on the total value of the fund represented at 5 million EUR. Given an average inflation rate of 15%, and not counting the additional expense of brokerage fees to buy and sell securities, the only entity making profit is PAM. The investor is left in the dust. The example aptly illustrates the unsophisticated assumptions of MiFID: that UCITS are safe and non-complex, and the trusting investor is not subject to a fleecing by investing in a presumed safe product.

The nettlesome issues from the viewpoint of the retail investor do not differ in substance from the conditions confronting investors in any developed market, such as the United States. Former SEC Chairman Arthur Levitt has identified the risks for individual investors; Burton G. Malkiel has identified the shortcomings of purported “managed funds” designed to justify high fees. Without disregarding his comprehensive analysis of the fund industry, Levitt focuses first and foremost on the issue of fees. Levitt aptly puts it, “high fees strangle returns”. In 2002, he noted that the US funds industry collected more than 50 billion a year in fees from investors. Levitt states that a fee of 2% is a punishing levy as his illustration tells. An investor placing 10,000 USD in a fund with a 2% management fee and a sales load of 3%, and earning 7.5% over twenty years, would earn $27,508, but have lost $14,970 in fees. He also states that, assuming payment of higher fees is equal to payment of services for “smarter managers” is a myth; it just means the investor is paying more money to the bank or investment company. Applying Levitt’s standards, if a 2% management fee is a punishing levy, then 3% is the equivalent of an investment execution. In addition, the precise fee scheme of PAM cannot be derived from reading the prospectus.

Significantly, PAM is one of the more successful purveyors of mutual funds. SEB’s performance is dismal. Take for example, SEB Choice Asia Small Caps ex. Japan Fund. Launched in 2003, with an NAV less than 2 EUR per unit, the fund’s value as of June 2008 was 2.698 per unit, providing an annualised return of 0.296%. The

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OMX Baltic Exchange does not provide any information as to prospectus or fees, rendering the web site of limited value. In any event, given broker commissions, and management fees, intuitively it is obvious that the investor has lost any reasonable expected return. That result takes us back to Levitt’s poignant message: what is the investor paying for: money management of little value or of high risk of loss.

Logic and experience next requires an assessment of payment for professional money management. This is the service being pushed by Baltic banks. However, the evidence is to the contrary. In a “Random Walk Down Wall Street”, Burton Malkiel marshals substantial evidence that payment for a professional money manager is a waste of resources. He makes his case as follows:

“An investor with 10,000 at the start of 1969 who invested in a Standard & Poor’s 500 – Stock Index would have had a portfolio worth $422,000 by 2006, assuming that all dividends were reinvested. A second investor who instead purchased shares in an actively managed fund would have seen his investment grow to $284 000. The difference is dramatic. Through March 31, 2006, the index investor was ahead by $138 000, an amount almost 50% greater than the final stake of the average investor in a managed fund.”

In the context of our Baltic market example, the professional money manager presumably would reply that the return is insubstantial compared to what could be gained with professional money management in the region. However, the cadre of young professionals running the investment funds have not realised until now that they have enjoyed the fruits of a stock market bubble. In fact, the Russian Federation, where many Baltic funds have realised substantial returns, arguably is not necessarily tied to financial acumen, but a market rising on sound economic fundamentals. Nevertheless, as already proved, the average fund on the Baltic Fund Centre list is losing money.

Former Chairman Levitt supports the efficient performance of index funds. He states, “The Fourth Deadly Sin is also the fund industry’s dirty little secret: most actively managed funds never do as well as their benchmark… For the year ended December

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96 A non-statistically valid review of prospectuses by the author reveals that the prospectus document does not identify the individual companies in which the funds assets are invested.

97 Malkiel B.G., n 95 pp 15-16.
30, 2001, 47 percent of domestic stock funds did not perform as well as the S & P 500, according to Morningstar, even though the S & P lost 13.4 %. And 2001 was one of the better years for managed funds.”

In spite of financial analysis and technical analysis, unless a trader has inside knowledge, selecting investments is like throwing darts at a board. Burton Malkiel is more caustic: “For a twenty-year period, 80% of large cap equity funds failed to outperform the Standard & Poor’s index.”

Since most money managers cannot beat the index, the nature of the regime appears to enrich the investment firm at the expense of the retail client. For example, an investor with $10,000 at the start of 1969 who invested in a Standard & Poor’s 500 Index Fund would have had a portfolio worth $422,000 by 2006, assuming that all dividends were reinvested. A second investor who instead purchased shares in the average actively managed fund would have seen his investment grow to $284,000. These results raise the question of whether the investor must be protected from the professional money manager, not the other way around as delineated by the MiFID investor protection policy.

The costs that firms incur to adapt their practices to the Directive will be passed onto the retail investor in the form of commission and fees. Given the probable level of commissions, the portfolio under management would have to perform at an exceptional level for the retail investor to obtain a substantial after-fee and after-tax return on his or her investment. MiFID strictures have the capacity of the sheep [the fund managers who cannot beat the S&P] taking the retail investors with them.

Part VI. Conclusion

The macroeconomic function of financial markets is unsettled and remains subject to debate among finance and economic scholars. Professor Stout makes a compelling
case that the conventional view is exaggerated and not supported by adequate empirical evidence. The value of capital actually transferred to the firms for use in production of social wealth may be relatively minor. Undoubtedly, the market serves the function of reallocation of wealth among anonymous investors in the secondary market, and securities constitute an important asset class in a diversified portfolio.

With the exception of enforcement, investor protection that takes the form of addressing informational asymmetries and inequality of bargaining power in the market are largely ineffective. In the context of securities markets, the delivery of prospectuses, proxy statements, and annual reports, though important, do not serve the needs of the retail investor, as the latter lack the skills required to draw conclusions from these documents to make informed investment decisions. Rather, there may be an inverse correlation between volume of information and investor protection, since as volume increases investors are less likely to read and analyse information. This critique is applicable equally to EU and US investor protection schemes. The verdict is still out on the efficacy of corporate law to curb corporate opportunity and to prevent management extraction of “private benefits” to shareholder detriment.

Intensity of enforcement is the *sine qua non* of effective investor protection. Professor Coffee’s empirical data do not bode well for the European Union. Though consumer protection is a key policy of the European Union and takes a position within the Treaty of the European Union, and though the European Union has adopted numerous Consumer Protection Directives, in the context of financial markets, and focusing upon the most basic violation “insider trading”, Professor Coffee has demonstrated that the public authorities fail to enforce the law, and thereby fail to protect investors. While the US may be more active in enforcement than the EU, enforcement intensity alone does not preclude volatility of the markets nor assure that firms follow appropriate risk management procedures. Without enforcement, the Market Abuse Directive remains ineffective.

A corollary problem is the problem of access to justice. The MiFID Directive, characteristic of most Directives, leaves enforcement to the Member States. In addition, like most recent Directives, the Directive encourages non-judicial settlement of disputes through arbitration and other alternative dispute resolutions. Empirical data is needed to assess the availability, cost, and fairness of existing ADR institutions
as to the prompt and just resolution of investment disputes. Nevertheless, the US
clearly has the edge over the EU in a retail investor’s access to the justice system.

MiFID has set the required legal framework to establish a Pan-European market
through “best execution”, “transparency”, and “linkages”. The potential to create an
active integrated financial market consisting of innovative platforms and facilities is
made possible by MiFID. Market forces in the US already have achieved integration
thereby providing support for the “law does not matter” thesis. The EU and the US
investor protection rules are virtually mirror images of on another, excepting the
mandatory client classification scheme.

The “client classification” scheme contains the virtue of striving to force firms to
accept responsibility to make informed and tailored recommendations to retail clients
in portfolio management. The back office operations of client order handling rules,
pre- and post-trade transparency of prices, routing alternatives, and provision of trade
confirmations, reports and account statements are vital to the investor. However, with
the exception of Article 19(5), the classification scheme, suitability and assessment
requirements, and conservative limits on trading activity subject to provision of
information, approvals, and warnings are paternalistic and inevitably expensive. In the
typical Wall Street manner these costs will be borne by Main Street to the benefit of
professional money managers, or in symbolic terms, “Wall Street”. The US has not
adopted a MiFID-like paternalistic scheme, and arguably should not.

Appendix A

Twenty Major Stock Exchanges In The World: Market Capitalization & Year-
to-date Turnover at the end of January 2009
<table>
<thead>
<tr>
<th>Region</th>
<th>Stock Exchange</th>
<th>Market Value (millions USD)</th>
<th>Total Share Turnover (millions USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td>Johannesburg Securities Exchange</td>
<td>432,422.1</td>
<td>17,999.7</td>
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<tr>
<td>Americas</td>
<td>NASDAQ</td>
<td>2,203,759.6</td>
<td>2,325,238.3</td>
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<tr>
<td>Americas</td>
<td>São Paulo Stock Exchange</td>
<td>611,695.0</td>
<td>30,748.5</td>
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<tr>
<td>Americas</td>
<td>Toronto Stock Exchange</td>
<td>997,997.4</td>
<td>84,323.0</td>
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<tr>
<td>Americas</td>
<td>New York Stock Exchange</td>
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<td>1,517,615.7</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>Australian Securities Exchange</td>
<td>587,602.7</td>
<td>37,400.1</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>Bombay Stock Exchange</td>
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<td>14,425.0</td>
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<td>Asia-Pacific</td>
<td>Hong Kong Stock Exchange</td>
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<td>80,696.8</td>
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<td>Asia-Pacific</td>
<td>Korea Exchange</td>
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<td>National Stock Exchange of India</td>
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<td>Shanghai Stock Exchange</td>
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<td>Asia-Pacific</td>
<td>Tokyo Stock Exchange</td>
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<td>Euronext</td>
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<td>146,173.3</td>
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<td>Frankfurt Stock Exchange (Deutsche Börse)</td>
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<td>264,970.3</td>
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<td>Europe</td>
<td>London Stock Exchange</td>
<td>1,758,157.7</td>
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<td>Europe</td>
<td>Madrid Stock Exchange (Bolsas y Mercados Españoles)</td>
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<td>Region</td>
<td>Stock Exchange Group</td>
<td>Value 1</td>
<td>Value 2</td>
</tr>
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<td>---------------------------</td>
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<td>---------</td>
</tr>
<tr>
<td>Europe</td>
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<td>Europe</td>
<td>Swiss Exchange</td>
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<td>63,435.6</td>
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</tbody>
</table>

*Note 1:* includes the Copenhagen, Helsinki, Iceland, Stockholm, Tallinn, Riga and Vilnius Stock Exchanges

- *Sources:* [World Federation of Exchanges - Statistics/Monthly](http://example.com)
Appendix B

Graham Analysis for IBM

Preliminary Note: Data provided in this assignment was drawn primarily from documents available on the website of IBM – balance sheets, historical archives, financial statements and so forth. I also used MSN and Yahoo Finance to double check the data, or to locate data I did not find on the IBM Website.

The Graham analysis contains the following criteria:

1) Sufficient size
2) Strong financial condition
3) Earnings stability
4) Dividend record
5) Earnings growth
6) Moderate P/E ratio
7) Moderate Price to Assets Ratio

The International Business Machines Corporation [IBM]

All data dated as of 17 April 2008

a. P/E Ratio 16.77
b. Dividend Yield 1.4%
c. Price 120.47 USD

Application of Graham Analysis

Sufficient Size

Graham requires of an industrial company, adjusted for inflation, annual sales of 465 million. Based on figures from fiscal year ending 31 December 2007, IBM had total revenues in the amount of 98.79 billion USD. Clearly the company is of sufficient size under the Graham analysis.

Strong Financial Condition

Graham requires a current ratio of at least 2 and that long-term debt should not exceed working capital by that ratio. The objective is to provide protection against bankruptcy. Current ration is calculated by the following formula: CR = CA/CL.

Based on IBM’s Balance Sheet for 31 December 2007, it had current assets in the amount of 53,177,000 [all numbers in thousands] and it had current liabilities in the amount of 44,310,000. The CR is 53,177,000/44,310,000 or a ration of 1.2. In itself, the current ration fails to meet the Graham minimum requirement of 2 as the higher the number the more capacity of the company to pay debts.
IBM has long-term debt of 23,573,000. Working capital is derived by the formula \( WC = CA - CL \). Therefore, IBM has WC equal to 53,177,000 – 44,310,000 or 8,867,000. The ratio of long-term debt to WE is equal to \( 23,573,000 / 8,867,000 \) or 2.658%. Since that ratio exceeds the CR of 1.2, IBM fails to meet the “sufficiently strong financial condition” criteria of the Graham analysis.

**Earnings Stability**

Graham defines earnings stability as not having reported a loss over a period of ten years. These figures were drawn from the IBM archives available on the IBM website.

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Income [in Billions]</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>6.32</td>
</tr>
<tr>
<td>1999</td>
<td>7.7</td>
</tr>
<tr>
<td>2000</td>
<td>8.1</td>
</tr>
<tr>
<td>2001</td>
<td>7.7</td>
</tr>
<tr>
<td>2002</td>
<td>3.58</td>
</tr>
<tr>
<td>2003</td>
<td>7.6</td>
</tr>
<tr>
<td>2004</td>
<td>8.4</td>
</tr>
<tr>
<td>2005</td>
<td>7.9</td>
</tr>
<tr>
<td>2006</td>
<td>9.4</td>
</tr>
<tr>
<td>2007</td>
<td>10.4</td>
</tr>
</tbody>
</table>

Accordingly, IBM meets the “earnings stability” test.

**Dividend Record**

Graham requires that a company have a history of paying dividends on its common stock for the past twenty years to assure that dividends are like to be paid.

A review of the historical records for dividend payments available on the IBM Website shows that IBM has consistently paid a dividend to common shareholders for the past 20 years 1987 through 2008. Therefore, the dividend record requirement of the Graham analysis is met.

**Earnings Growth**

Graham states that net income should have increased by one-third or greater on a per share basis over the course of the past ten years using three-year averages at the beginning and end of the period.

<table>
<thead>
<tr>
<th>Year</th>
<th>EPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>7.18</td>
</tr>
<tr>
<td>Year</td>
<td>P/E</td>
</tr>
<tr>
<td>-------</td>
<td>------</td>
</tr>
<tr>
<td>2006</td>
<td>6.11</td>
</tr>
<tr>
<td>2005</td>
<td>4.87</td>
</tr>
<tr>
<td>Average</td>
<td>6.05</td>
</tr>
<tr>
<td>1999</td>
<td>4.12</td>
</tr>
<tr>
<td>1998</td>
<td>3.29</td>
</tr>
<tr>
<td>1997</td>
<td>3.00</td>
</tr>
<tr>
<td>Average</td>
<td>3.47</td>
</tr>
</tbody>
</table>

Result: The increase is approximately 57%; therefore, the Graham criterion is met.

**Moderate Price to Earnings Ratio**

The P/E should not exceed 15 times its average earnings over the past three years. Data was compiled by dividing Price at year’s end by EPS for year. Data to compute numbers was taken from IBM financial statements.

<table>
<thead>
<tr>
<th>Year</th>
<th>P/E</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>16.77</td>
</tr>
<tr>
<td>2006</td>
<td>15.9</td>
</tr>
<tr>
<td>2005</td>
<td>17.3</td>
</tr>
</tbody>
</table>

Technically, though close, IBM’s P/E for the last three years exceeds Graham’s criterion that the P/E not exceed 15 times earnings.

**Moderate Ratio of Price to Assets**

Graham states that current price should not exceed 1 and one-half times the last reported book value.

According to MSN Finance, key ratios, the current price to book value is 5.81. Therefore, IBM fails to meet the Graham criterion. However, if we look at Price to Assets, the conclusion may differ. The total assets are 120,432,000 [in thousands] and the price is 120.47 demonstrates a moderate price in relation to total assets.

**Conclusion**

The financial data for IBM does not satisfy all Graham criteria. IBM meets sufficient size, dividend record, earnings growth, and earnings stability. It does not meet P/E ratio, Price to Assets ratio, and strong financial condition.