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MEASURES FOR PREVENTING AND MANAGING CONFLICTS OF INTEREST IN INVESTMENT FIRMS

Abstract

In this paper the author analyses selected measures for preventing and managing conflicts of interest in investment firms. The first part of the paper discusses prevention and management of conflicts as possible goals of specific regulation. Here, the author emphasises the shift in regulatory approach on the EU level, given the fact that MiFID and its implementing directive require effective management of conflicts of interest instead of prevention of their occurrence, which differs from the position of the previous Investment Services Directive. The main part of the paper deals with the selected concrete measures for preventing and managing conflicts of interest. The author has chosen to analyse those measures that are most commonly used and are of the greatest importance as a way of tackling conflicts-of-interest problems. These measures include: separation of functions, refraining from trade and/or provision of services (restricted and stop lists, no-recommendation policies) and organisational measures (Chinese Walls, watch lists, compliance officers). The analysis of a specific regulation and legal effects of implemented measures is primarily based on Serbian and EC law. To this end, the author uses a comparative approach in order to show the discrepancies between solutions adopted by these two systems, which leads to the conclusion that Serbian regulatory approach is obsolete and needs to be updated with the latest developments in this field.

Key words: *capital market, conflict of interest, prevention, management, MiFID, Serbian law.*

I. INTRODUCTION

Conflicts of interest in investment firms arise when a firm has a duty of loyalty to one client and needs to decide how to act in the best interest of that client, while effects of such a decision run counter to the self-interest of the firm or an interest of another client, to whom the firm also owes a duty of loyalty.[1] Such conflicts normally

1 Cf., C. M. Gorman, 'Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers?', 9 *Fordham Journal of Corporate & Financial Law* (2004) p. 475 at p. 480; M. Kruithof, *Conflicts of Interest in Institutional Asset Management: Is the EU*

occur in the course of doing investments business. The main reason for this is that investment firms as a rule have a duty of loyalty towards their clients,[2] on the one hand, and perform many different functions (i.e., investment services and activities) in the capital market as financial conglomerates,[3] on the other. Establishing a duty of loyalty is, however, not enough for conflicts of interest to arise. In addition to that, the investment firm must have discretionary power to decide how to act in the client's best interest.[4] Finally, the investment firm must have a self-interest or a duty of loyalty to another client that conflicts with the fulfilment of the duty of loyalty to the first client.[5]

In today's multi-functional firms (i.e., financial conglomerates) conflicts of interest have become inevitable.[6] Nevertheless, they are a cause for concern, because of significant problems that result from information asymmetry between the investment firm and its clients,[7] as well as the consequent moral hazard of the investment firm which has no incentive to comply with the agreed duty of loyalty.[8] The aforementioned problems have serious repercussions for the capital market as a whole.[9] Unsanctioned conflicts of interest have a negative impact on investors' confidence not only in the investment firm but also in the proper functioning of the capital market, which can undermine its overall efficiency and integrity.[10] This is

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Regulatory Approach Adequate?, Financial Law Institute, Working Paper Series, 2005-07, 2005, available at: *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=871178*, p. 2; C. Kumpan and P. C. Leyens, 'Conflicts of Interest of Financial Intermediaries – Towards a Global Common Core in Conflicts of Interest Regulation', 1 *European Company and Financial Law Review* (2008) p. 72 at p. 84; N. S. Poser, 'Chinese Wall or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the U.S. and the U.K', 9 *Michigan Yearbook of International Legal Studies* (1988) p. 91 at p. 94.

2 J. I. Gross, 'Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud?', 2002 *Columbia Business Law Review* (2002) p. 631 at p. 636.

3 C. Kumpan and P. C. Leyens, loc. cit. n. 1, at p. 80; C. M. Gorman, loc. cit n. 1, at p. 481; M. Kruithof, op. cit. n. 1, at p. 14; N. S. Poser, loc. cit. n. 1, at pp. 94 and 98; H. McVea, 'Financial Conglomerates and Conflicts of Interest: Resolving a Regulatory Dilemma', 47 *Northern Ireland Legal Quarterly* (1996) p. 239 at p. 240; I. Walter, *Conflicts of Interest and Market Discipline Among Financial Services Firms*, 2003, available at: *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1297774*, p. 9.

4 M. Kruithof, op. cit. n. 1, at pp. 3 and 4; C. Kumpan and P. C. Leyens, loc. cit. n. 1, at pp. 79, 80, 82 and 83.

5 An interest of a connected person (e.g., an affiliated company) is treated in the same way as an investment firm's self-interest.

6 I. Walter, op. cit. n. 3, at p. 1.

7 C. Kumpan and P. C. Leyens, loc. cit. n. 1, at p. 80; about the problem of information asymmetry in the context of conflicts of interest, see: J. A. C. Santos, *Commercial Banks in the Securities Business: A Review*, (Basle, Bank for International Settlements, Working Papers No. 56 1998), available at: *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=8029*, p. 10.

8 M. Kruithof, op. cit. n. 1, at p. 8.

9 R. Bahar and L. Thévenoz, eds., *Conflicts of Interest: Corporate Governance and Financial Market* (Kluwer Law International 2006) p. 4.

10 M. Kruithof, op. cit. n. 1, at pp. 9, 21 and 22; L. Enriques, *Conflicts of Interest in Investment Services: The Price and Uncertain Impact of MiFID's Regulatory Framework*, 2005, available at: *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=782828*, p. 4; H. McVea, loc. cit n. 3, at pp. 241

why legislators all over the world pay special attention to enacting adequate specific rules with regard to conflicts of interest in investment firms.

The main purpose of specific regulation of conflicts of interest is to stimulate their prevention and management, as well as to give incentive for disclosure of conflicts and offer sanctions which can adequately punish but also deter investment firms from abusing these conflicts to the detriment of their clients. This paper aims at exploring the specific measures for preventing and managing conflicts of interest that exist in current comparative law and practice. In this regard special emphasis will be given to EC and Serbian rules on conflicts of interest. In the EU these rules are harmonised by MiFID and its implementing directive,[11] whereas in Serbia they are part of the Law on Market in Securities and Other Financial Instruments [*Zakon o tržištu hartija od vrednosti i drugih finansijskih instrumenata*] of 25th May 2006 (hereafter, *ZTHOV*).[12]

II. PREVENTING VS. MANAGING CONFLICTS OF INTEREST

Measures regarding conflicts of interest can have several purposes, which include the following: prevention, management, disclosure and sanctioning. Some of these purposes such as prevention, management and disclosure apply to the period *ex ante*, i.e., before the abuse of a conflict has taken place, while sanctioning refers to the period *ex post*, i.e., after the abuse. Generally, a distinction can be drawn between preventing conflicts of interest themselves and preventing their abuse. However, in this paper the term 'prevention' is used in the former sense, so that it signifies preventing the occurrence of conflicts of interest. Conversely, prevention of abuse of conflicts is primarily achieved by managing and disclosing existing conflicts of interest, but to a lesser extent also by deterring effects of sanctions for abuse (i.e., the fear of being effectively sanctioned).

This paper focuses on measures for preventing the occurrence of conflicts of interest and managing conflicts as a way of preventing their abuse. On the other hand, disclosing conflicts of interest and sanctioning their abuses, including the possible deterring effect of stipulated sanctions, will not be further discussed.

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and 250; A. Crockett, T. Harris, F. S. Mishkin, E. N. White, *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?*, Geneva Reports on the World Economy 5 (International Center for Monetary and Banking Studies, Centre for Economic Policy Research 2003) pp. xix and 2.

11 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, *Official Journal* L 145, 30.4.2004 (hereafter, MiFID), Art. 13(3) and 18; Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (Text with EEA relevance), *Official Journal* L 241, 2.9.2006 (hereafter, MiFID Implementing Directive), Art. 21–23.

12 Law on Market in Securities and Other Financial Instruments [*Zakon o tržištu hartija od vrednosti i drugih finansijskih instrumenata*], *Official Gazette of the Republic of Serbia*, No. 47/2006 (hereafter, *ZTHOV*), Art. 161 and 162.

1. EC law

EC law has undergone significant changes in respect of these issues. Namely, the former Investment Services Directive gave priority to prevention of conflicts of interest themselves.[13] Therefore, investment firms had a duty to avoid as much as possible conflicts of interest that could arise in the course of their business. This provision meant greater reliance on measures for preventing conflicts, instead of measures for their effective management. However, if conflicts of interest arose despite fulfilling this duty, investment firms had an obligation to treat their clients fairly. The legislation currently in force in the EU has drastically changed this conception. MiFID and its implementing directive no longer require investment firms to prevent conflicts of interest themselves. Instead, they primarily rely on measures for effective management of existing conflicts in order to avoid their detrimental effect on clients.[14]

The above-mentioned turn in EC regulation is a result of a different understanding of conflicts of interest and their problems. Due to the development of multi-functional firms (i.e., financial conglomerates), the occurrence of conflicts of interest has become inevitable in doing investment business.[15] Therefore, the only way for the investment firm to completely avoid conflicts of interest would be to provide just one service to just one client and to do this without compensation and without being engaged in investment activity for its own account.[16] It goes without saying that this way of doing investment business would not only be highly impractical, but would also significantly impair market efficiency in a given country. Legislators are becoming increasingly aware of the fact that conflicts of interest cannot be avoided in today's reality, where investment services are dominantly provided by multi-service firms. Hence, contemporary EC legislation insists on managing conflicts of interest instead of demanding the almost impossible, i.e., preventing their occurrence in doing investment business.

2. Serbian Law

Unfortunately, Serbian law has not yet followed the described changes in thinking about prevention and management of conflicts of interest. Its solutions regarding these issues are still based on the old Investment Services Directive. Consequently, the Serbian *ZTHOV* requires broker-dealer firms to limit as much as possible the occurrence of conflicts of interest in their investment business.[17] On the other hand, there is no general provision in the *ZTHOV* that regulates a duty of broker-dealer firms to manage conflicts of interest. The only exception in that respect is the broker-dealer's duty of equal treatment of clients, although this duty

13 Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, *Official Journal* L 141, 11.6.1993 (hereafter, Investment Services Directive), Art. 10 and 11(1).

14 MiFID, Art. 13(3); MiFID Implementing Directive, Art. 22.

15 I. Walter, op. cit. n. 3, at p. 1.

16 Cf., N. S. Poser, 'Conflicts of Interest within Securities Firms', 16 *Brooklyn Journal of International Law* (1990) p. 111 at p. 121.

17 *ZTHOV*, Art. 162(3).

has a rather limited scope of application since it applies only to conflicts of interest between two clients of a broker-dealer firm (i.e., conflicts of duty and duty).[18]

It can be concluded that Serbian law has no regulatory requirements imposed on broker-dealer firms to effectively manage conflicts of interest. In addition to that, Serbian regulation of conflicts of interest does not provide for any legal consequences in favour of broker-dealer firms who effectively manage conflicts of interest so as to prevent their detrimental effect on clients. Hence, the non-existence of regulatory requirements and incentives for managing conflicts of interest logically causes the lack of interest of broker-dealers in applying such measures when providing investment services for their clients.

III. CONCRETE MEASURES FOR PREVENTING AND MANAGING CONFLICTS OF INTEREST

There are many regulatory and practical measures aimed at preventing and/or managing conflicts of interest, some of which are not explicitly regulated. For this reason, the list of concrete measures cannot be exhaustive, so investment firms are free to invent and apply other measures that meet the goals of prevention and management of conflicts. Since one measure can at the same time serve both regulatory purposes (i.e., prevention of conflicts and their effective management), there is no justification for dividing them according to this criterion.

The most important and common measures that will be discussed in more detail include the following: 1. separation of functions, 2. refraining from trade and/or provision of services, 3. organisational measures, and 4. equal treatment of clients.

1. Separation of functions

Separation of functions is sometimes referred to as 'deconglomeration'.[19] This measure encompasses the establishment of separate legal entities for performing different functions (investment services and/or activities) in the capital markets.[20] For example, one investment firm is established for providing broker services, whereas another is established for performing dealer activities in the market. The main purpose of this measure is to prevent the occurrence of conflicts of interest, given the fact that performing more than one function in the capital market by a single investment firm inevitably increases the number of conflicts of interest in the

18 Regarding conflicts of duty and duty, see: H. McVea, loc. cit n. 3, at p. 240; R. Cranston, 'Conflicts of Interest in the Multifunctional Financial Institution', 16 *Brooklyn Journal of International Law* (1990) p. 125 at p. 125; I. Walter, op. cit. n. 3, at p. 3.

19 H. McVea, loc. cit n. 3, at p. 258.

20 C. M. Gorman, loc. cit n. 1, at p. 497. Cf., A. Crockett, T. Harris, F. S. Mishkin, E. N. White, op. cit. n. 10, at p. 8, where separation of functions is defined in a wider sense, so that it includes different degrees of separation, such as: 1) separate in-house departments with firewalls between them, 2) separately capitalised affiliates, and 3) prohibition of combination of activities in any organisational form. In this paper the term 'separation of functions' is used in the last sense, meaning complete prohibition of combination of activities.

course of its business. In other words, this measure eliminates one of the causes of conflicts of interest and thereby enables prevention of their occurrence.

In the past, regulatory requirement of separation of functions was a much more popular measure for preventing conflicts of interest. A good example of this is the law of Great Britain, where prohibition was imposed on investment firms to provide broker services and engage in dealer activities at the same time, which was in force until 1986.[21] Segregation of functions as a measure for preventing conflicts of interest is still used by contemporary legislators, but to a far lesser extent.[22] Legislators opt for this measure only in situations where conflicts of interest are inherent in doing certain conflicting businesses, so that it cannot reasonably be expected from market participants to effectively manage these conflicts. Therefore, Serbian law prescribes separation of functions in the case of operating a stock exchange and providing broker-dealer services.[23] This means that a single market participant cannot at the same time organise a stock exchange and be a broker-dealer, since inherent conflicts of interest that would arise out of that situation cannot be overcome by using other measures for their prevention and management.

The main reason why using separation of functions as a regulatory measure has lost its former significance lies in the fact that strict division into specialised market participants lessens the advantages of creating financial conglomerates or multi-functional investment firms.[24] Establishing separate legal entities for performing specific roles in the capital market leads to multiplying the overall costs of providing investment services and hence to the loss of savings that could otherwise be achieved through economies of scope ('2+2=5' principle).[25] Apart from these purely economic reasons, separation of functions is not a popular measure also because it requires complete division of entities that perform different functions in the market.[26] This stems from the fact that prevention of conflicts of interest cannot be achieved if two market participants formally represent separate legal entities, while in fact they are closely connected through share in capital and form a part of a

21 N. S. Poser, loc. cit. n. 1, at pp. 92 and 95. The requirement for separation of functions was abolished after the Big Bang, when a principle of single capacity was introduced. R. Cranston, loc. cit. n. 18, at p. 138. About the creation of financial conglomerates in Great Britain after the Big Bang, see: H. McVea, loc. cit n. 3, at p. 240.

22 This measure is considered to be draconian, since as a rule, it is not necessary to prevent conflicts of interest themselves, but instead, it suffices to provide for mechanisms for their adequate control. H. McVea, loc. cit n. 3, at p. 258.

23 *ZTHOV*, Art. 79.

24 The main advantage consists of creating synergies of information collection. See: A. Crockett, T. Harris, F. S. Mishkin, E. N. White, op. cit. n. 10, at p. 8; H. McVea, loc. cit n. 3, at p. 248; for negative aspects of separation of functions, see: M. Lipton, R. B. Mazur, 'The Chinese Wall Solution to the Conflict Problems of Securities Firms', 50 *New York University Law Review* (1975) p. 459 at p. 495; for advantages of creating financial conglomerates, see: N. S. Poser, loc. cit. n. 1, at p. 98.

25 A. Crockett, T. Harris, F. S. Mishkin, E. N. White, op. cit. n. 10, at p. 8; C. M. Gorman, loc. cit n. 1, at p. 497; N. S. Poser, loc. cit. n. 1, at p. 139; about the notion and significance of economies of scale see: H. McVea, loc. cit n. 3, at pp. 247 and 248.

26 Creating subsidiaries does not mean avoiding all types of conflicts of interest. See: R. Cranston, loc. cit. n. 18, at p. 139.

group of companies.[27] The said conclusion is derived from the fact that an interest of one company which belongs to a group of companies is treated as a self-interest of a connected company (i.e., another company of that group), which prevents the achievement of the desired effect of separation of functions.

2. Refraining from trade and/or provision of services

Refraining from trade and/or provision of services serves both as a mechanism for preventing the occurrence of conflicts of interest and as a mechanism for effective management of existing conflicts.[28] This measure signifies a prohibition to trade and/or offer investment services (especially to initiate trade) regarding financial instruments that are the subject of actual or potential conflicts of interest between the investment firm and its customers. As a rule, legislators do not explicitly require investment firms to implement this mechanism for preventing and managing conflicts of interest. Instead, they leave it to investment firms to make these issues a part of their self-regulation.[29] Accordingly, an investment firm will introduce self-imposed limitations concerning trade and/or provision of services, when it is aware that conflicts of interest or possessing inside information about certain financial instruments run counter to fulfilling its duty of loyalty towards clients.[30] For example, a broker-dealer firm buys some securities for its own account and then makes a decision that it will not offer any (e.g., brokerage, portfolio management or investment advice) services regarding these securities to its clients. Unfortunately, given the fact that refraining from trade and/or provision of services is not explicitly regulated in Serbian law, as well as the fact that enforcement of specific regulation concerning conflicts of interest is very poor, Serbian broker-dealer firms lack any incentive to self-impose this measure in order to protect their clients.

In practice, an investment firm implements this measure by creating a list of financial instruments regarding which it will not perform transactions, make recommendations or otherwise initiate transactions. However, there are several variations of refraining from trade and/or provision of services. Firstly, an investment firm can adopt a no-recommendation policy and thereby refrain from recommending certain financial instruments to its customers.[31] When this measure is implemented, the investment firm is still allowed to deal in financial instruments for its own account, as well as to execute unsolicited orders of its clients.[32] Secondly, an investment firm can place certain financial instruments on a so-called 'restricted list'. In that case, the firm will refrain not only from recommending these

27 R. Bahar and L. Thévenoz, eds., op. cit. n. 9, at p. 17.

28 Cf., R. Bahar and L. Thévenoz, eds., op. cit. n. 9, at p. 14; R. Cranston, loc. cit. n. 18, at pp. 129 and 130.

29 Sometimes this measure is regulated by professional associations. See: R. Bahar and L. Thévenoz, eds., op. cit. n. 9, at p. 12.

30 Refraining from trade and/or provision of services should be applied as soon as the investment firm enters into a close business relationship with the issuer of certain financial instruments. See: R. Cranston, loc. cit. n. 18, at p. 130; C. M. Gorman, loc. cit n. 1, at p. 495.

31 Cf., H. McVea, loc. cit n. 3, at p. 257.

32 H. McVea, loc. cit n. 3, at p. 257.

instruments to its clients, but also from own-account trading.[33] On the other hand, some authors believe that execution of unsolicited orders should be permitted in spite of the implementation of a restricted-list procedure.[34] Thirdly, an investment firm can create a so-called 'stop list', which is the strictest variation of this measure. Hence, when financial instruments are added to this type of list, an investment firm is barred from performing any sort of investment activity or services regarding those instruments.[35]

There are several obvious advantages of refraining from trade and/or provision of services as a measure against conflicts of interest. Namely, an investment firm in advance avoids those activities or services that conflict with its self-interest regarding certain financial instruments. This practice makes any abuse of conflicts of interest impossible. On the other hand, refraining from trade and/or provision of services also has some negative aspects. Implementing this measure against conflicts of interest impairs the firm's competitiveness in the market, bearing in mind that it performs activities and provides services concerning fewer financial instruments in comparison to other investment firms.[36] Moreover, placing financial instruments on a restrictive (i.e., stop) list can sometimes signal the fact that the investment firm possesses inside information or has a personal interest in connection with those instruments.[37] Since investment firms generally prefer that their self-interest and possession of inside information remain undisclosed to the public, the above-mentioned negative effect of this measure lessens its attractiveness for tackling conflict-of-interest problems.

3. Organisational measures

Organisational measures constitute a mechanism for managing existing conflicts of interest by investment firms. They consist of internal procedures and measures within an investment firm which prevent conflicts of interest from having detrimental effects on clients. Considering that managing conflicts of interest is currently one of primary goals of specific regulation, the use of organisational measures is becoming increasingly popular. There are different types of these measures, which are usually combined in order to achieve the best results in preventing abuse of conflicts of interest to the detriment of clients. The most commonly used organisational measures include the following: a) Chinese Wall; b) watch lists; and c) compliance officers.

On the EU level, MiFID requires investment firms to apply organisational measures so as to avoid adverse effects of conflicts of interest on their clients.[38]

33 H. McVea, loc. cit n. 3, at p. 257; N. S. Poser, loc. cit. n. 16, at p. 118.

34 L. Herzel and D. E. Colling, 'The Chinese Wall and Conflict of Interest in Banks', 34 *The Business Lawyer* (1978–1979) p. 73 at p. 84; M. Lipton and R. B. Mazur, loc. cit. n. 24, at p. 499; H. McVea, loc. cit n. 3, at p. 257.

35 H. McVea, loc. cit n. 3, at p. 257; cf., M. Lipton and R. B. Mazur, loc. cit. n. 24, at p. 492.

36 N. S. Poser, loc. cit. n. 1, at p. 143; cf., H. McVea, loc. cit n. 3, at p. 257.

37 C. M. Gorman, loc. cit n. 1, at pp. 494 and 495; H. McVea, loc. cit n. 3, at p. 257; N. S. Poser, loc. cit. n. 1, at p. 109; N. S. Poser, loc. cit. n. 16, at p. 118.

38 MiFID, Art. 13(3). M. Kruithof, op. cit. n. 1, at p. 39.

Contrary to this rule, Serbian law stipulates a duty of broker-dealer firms to implement organisational measures for preventing the occurrence of conflicts of interest as such.[39] In other words, Serbian provisions with regard to organisational measures have a different regulatory purpose in comparison with the requirements of the EU law (i.e., prevention as opposed to management of conflicts). In addition to that, Serbian *ZTHOV* does not provide for any guidance concerning types of organisational measures that would suffice to fulfil the imposed duty of broker-dealers. Unlike the EU law, where the MiFID Implementing Directive further elaborates *exempli causa* concrete types of organisational measures,[40] Serbian law does not contain any examples as to how broker-dealer firms could organise their business so that conflicts of interest are avoided as much as possible. Finally, in Serbian law the non-performance of duty to implement organisational measures is not supported by appropriate sanctions. The only potential sanctions can be derived from the general law of obligations, according to which clients of the broker-dealer firm have a right to claim damages and to cancel their contract on investment services when this duty is neglected.[41] However, considering that there are no penal sanctions for breach of this duty[42] and that damages cannot be derived simply from the fact that conflicts of interest have arisen although they have not yet been abused to the detriment of clients, the duty to implement organisational measures has little significance in Serbian practice.

a. Chinese Wall

Chinese Wall, also sometimes referred to as 'information barriers'[43], is a metaphor used to describe internal rules and procedures designed to prevent the flow of confidential information between different departments of an investment firm.[44] In practice, 'erecting' a Chinese Wall means implementing a combination of several measures that can include the following: physical separation of departments (e.g., separate elevators, different parts of building or different buildings), restricted access to files, educational program for employees, controlled procedures for the movement of personnel between different departments, etc.[45] This mechanism for dealing with conflicts of interest was developed in the United States, where at first it served as a means of tackling problems of insider dealing.[46] Hence, the main

39 *ZTHOV*, Art. 162(3).

40 MiFID Implementing Directive, Art. 22(3).

41 It goes without saying that damages can only be recovered if the client can prove the causal relationship between the broker-dealer's breach of duty and his material loss.

42 Cf., *ZTHOV*, Art. 250(1)(31).

43 L. Aitken, "Chinese Walls' and Conflicts of Interest', 18 *Monash University Law Review* (1992) p. 91 at p. 92; C. Kumpan and P. C. Leyens, loc. cit. n. 1, at p. 86.

44 C. Kumpan and P. C. Leyens, loc. cit. n. 1, at p. 86; R. Cranston, loc. cit. n. 18, at pp. 129 and 139; L. Aitken, loc. cit. n. 43, at p. 92; N. S. Poser, loc. cit. n. 1, at pp. 91 and 92; H. McVea, loc. cit n. 3, at p. 239; L. Herzel, D. E. Colling, loc. cit. n. 34, at pp. 74 and 80. Another suggested term for the Chinese Wall is the 'Don't tell your partner' technique. See: M. Lipton and R. B. Mazur, loc. cit. n. 24, at p. 462.

45 L. Herzel and D. E. Colling, loc. cit. n. 34, at pp. 88–91; R. Cranston, loc. cit. n. 18, at p. 139; C. Kumpan and P. C. Leyens, loc. cit. n. 1, at p. 86; cf., H. McVea, loc. cit n. 3, at p. 250.

46 N. S. Poser, loc. cit. n. 1, at p. 103; N. S. Poser, loc. cit. n. 16, at p. 112; M. Kruithof, op. cit. n. 1, at p. 42; S. Dolgopolov, 'Insider Trading, Chinese Walls, and Brokerage Commissions: the Origins

purpose of the Chinese Wall is to prevent the free exchange of information within an investment firm,[47] which results in ignorance of the conflict of interest in those departments that do not have direct access to information that gives rise to the conflict.

As a measure for managing conflicts of interest, Chinese Wall has several disadvantages. Firstly, this technique lessens the benefits of creating financial conglomerates.[48] Secondly, efficiency of the Chinese Wall concerning the prevention of abuse of conflicts of interest is open to debate.[49] Undoubtedly, this measure is inapplicable in small investment firms, where only a few persons are responsible for making all business decisions,[50] since a psychological Wall cannot serve its purpose.[51] On the other hand, in large investment firms Chinese Walls are highly complex, which makes it difficult to effectively oversee their functioning. Finally, the implementation of Chinese Walls presents a specific problem because of the fact that one arm of the firm would not know what the other arm is doing,[52] which could result in contradictory business actions by different departments of the investment firm.[53]

In the EU law, the MiFID Implementing Directive explicitly mentions 'procedures to prevent or control the exchange of information' (i.e., Chinese Wall) as one of the examples of possible organisational measures to manage conflicts of interest.[54] In contrast, Serbian law contains no provisions that regulate Chinese Walls or their legal impact on fulfilling duties of broker-dealer firms with regard to conflicts of interest. Besides, Chinese Walls cannot be used to satisfy the duty of minimising the occurrence of conflicts of interest, since their effect is limited to managing existing conflicts instead of preventing potential ones. As a consequence, Serbian broker-dealers have no incentive whatsoever to implement these procedures.

b. Watch list

A watch list represents a list of financial instruments whose trading is monitored by the investment firm.[55] This organisational measure is commonly used in addition to the Chinese Wall. Its main purpose is to enable monitoring of trade in financial

of Modern Regulation of Information Flows in Securities Markets', 4 *Journal of Law, Economics & Policy* (2008) p. 311 at p. 347.

47 M. Kruithof, op. cit. n. 1, at p. 42.

48 M. Kruithof, op. cit. n. 1, at p. 43; N. S. Poser, loc. cit. n. 16, at p. 115.

49 H. McVea, loc. cit n. 3, at pp. 251–253; N. S. Poser, loc. cit. n. 16, at pp. 113–115. Uncertainties regarding the efficiency of this measure for managing conflicts of interest have caused the development of the so-called 'reinforced Chinese Wall'. A Chinese Wall is reinforced when it is supported by some other measure for preventing or managing conflicts, such as no-recommendation policies and restricted or stop lists. See: R. Cranston, loc. cit. n. 18, at p. 139; N. S. Poser, loc. cit. n. 1, at p. 108; H. McVea, loc. cit n. 3, at pp. 256 and 257; M. Lipton, R. B. Mazur, loc. cit. n. 24, at p. 499.

50 L. Herzel and D. E. Colling, loc. cit. n. 34, at pp. 91 and 92.

51 Cf., H. McVea, loc. cit n. 3, at p. 251; N. S. Poser, loc. cit. n. 16, at p. 115.

52 R. Cranston, loc. cit. n. 18, at p. 142; cf., N. S. Poser, loc. cit. n. 16, at p. 118.

53 C. Kumpan and P. C. Leyens, loc. cit. n. 1, at p. 86.

54 MiFID Implementing Directive, Art. 22(3)(a).

55 C. M. Gorman, loc. cit n. 1, at p. 495.

instruments by the investment firm and its employees in order to determine whether the Wall has been crossed.[56] Since certain unusual dealings in financial instruments can signal that there has been information leakage from one department to the other, the implementation of a watch list contributes to enhancing the efficiency of the Chinese Wall.[57]

c. Compliance officers

Another organisational measure that can be implemented to support the efficiency of the Chinese Wall is the appointment of compliance officers.[58] The main purpose of compliance officers is to control the functioning of the Chinese Wall. In that respect, they have the authority to demand information, lay down procedures and instruct on the steps that need to be taken whenever the Wall has been crossed.[59] Consequently, every crossing of the Wall has to be notified to the compliance officers.[60]

4. Equal treatment of clients

The principle of equal treatment of clients is the primary measure for managing conflicts of interest between duty and duty. The principal way by which an investment firm can manage conflicts of interest between two or more of its clients is to apply rules that enable their equal treatment. Therefore, Serbian law requires broker-dealer firms to comply with the principle of equal treatment of clients and to specify rules with regard to the sequence of executing clients' orders.[61] These rules need to be based on objective criteria, so that the broker-dealer firm cannot favour interests of one client over interests of another. In comparison to Serbian, the EU law does not explicitly prescribe equal treatment of clients as a measure for managing conflicts of interest. However, given the fact that the list of measures for managing conflicts of interest in the MiFID Implementing Directive is not exhaustive, Member States can require investment firms to set out rules on equal treatment of clients that deal with specific problems of conflicts between duty and duty.[62]

IV. CONCLUSION

Serbian law on conflicts of interest is not up-to-date with the current EC legislation regarding these issues. While in the EU the emphasis of regulation is placed on management of conflicts of interest so as to prevent their abuse by an investment firm to the detriment of its clients, Serbian regulation is still set to achieve prevention of the occurrence of conflicts in investment business. In addition to that,

56 C. M. Gorman, loc. cit n. 1, at p. 495; C. Kumpan and P. C. Leyens, loc. cit. n. 1, at p. 85 footnote 60; N. S. Poser, loc. cit. n. 16, at p. 118.

57 Cf., C. M. Gorman, loc. cit n. 1, at p. 495.

58 R. Cranston, loc. cit. n. 18, at p. 139.

59 R. Cranston, loc. cit. n. 18, at p. 140.

60 C. Kumpan and P. C. Leyens, loc. cit. n. 1, at p. 87.

61 *ZTHOV*, Art. 134(2)(2) and 161(1).

MiFID Implementing Directive, Art. 22(3).

Serbian legislation contains only a few, laconic provisions concerning prevention of conflicts of interest, unlike the EU where the MiFID Implementing Directive provides for detailed rules on measures for effective management of existing conflicts. The Serbian *ZTHOV* generally neither requires broker-dealer firms to manage conflicts of interest, nor offers guidance on concrete measures that could be applied to satisfy their regulatory duties. Furthermore, Serbian legislation does not provide for necessary legal effects of potential measures against abuse of conflicts of interest, so there is no incentive to comply with the imposed duties in that regard. Finally, even the provisions concerning measures for prevention of conflicts of interest are not supported by satisfactory sanctions that could give true meaning to their mandatory character. The described state of Serbian law has caused the lack of interest of broker-dealer firms to implement adequate measures in an attempt to solve conflict-of-interest problems, which is why a complete revision of current rules on conflicts of interest in Serbia is urgently needed.