

Securities Intermediaries in the Internet Age and the Traditional Principal-Agent Model of Regulation: Some Observations from the EU's Markets in the Financial Instruments Directive*

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Abstract

The regulation of securities intermediaries such as brokers and broker-dealers has hitherto been based on agency issues arising out of the client-intermediary relationship. This paper argues that, even in the Internet age where the interaction between clients and intermediaries take place over the Internet, the agency rationale for regulation remains. However, the modalities of client-intermediary interaction take on certain characteristics that may affect the substantive regulation. As such, this paper examines the EU's recently enacted Markets in Financial Instruments Directive to discern to what extent the Directive addresses new modalities in client-intermediary interactions over the Internet.

Keywords: securities, securities intermediaries, brokers, broker-dealers, agency, asymmetrical information, Alternative Trading Systems.

1. Introduction

The regulation of securities intermediaries such as brokers and broker-dealers has hitherto been based on agency issues arising out of the client-intermediary relationship. The rise of the financial intermediary was characterized by Professor Clark as representing an advanced stage of capitalism in the development of modern capitalistic civilization. In this stage, capital suppliers concentrate on whether they should relinquish their funds to a particular intermediary, and the intermediary to a greater or lesser extent would be competent to advice on investment choice. The intermediary's brokerage services is essential to match suppliers and issuers of capital in the modern economy and securities intermediaries are in a position of relative trust and confidence vis a vis their capital supplying clients. The rise in financial intermediation has been empirically studied to bear a direct correlation with economic development, as financial intermediation is closely related to the growth of capital markets. (Chen (2006), Gorton and Winton (2002))

The nature of the intermediary as agent inexorably raises questions of whether the agency relationship may give rise to concerns that require regulation. The "traditional" model of regulation of the principal-agent relationship in securities transactions is based on the following rationales: agency issues arising out of asymmetrical information, fraud, insolvency and custodianship. As insolvency and custodianship deals with how the law regards assets held by intermediaries if they should become insolvent, bearing in mind that many assets may include client assets and borrowed stock, the discussion in this area is very specialized and would not be dealt with in this paper. This paper focuses on the ongoing relational aspects of client-intermediary interactions and the regulation pertaining to such. The two issues in the relational aspect of client-intermediary interactions that warrant regulation of the relationship are asymmetrical information and fraud. (Pacces ,2000)

Information asymmetry refers to the client's relative weaker position in knowledge vis a vis the intermediary, in terms of the investment activity i.e. the mechanics of buying or selling a security product, in terms of the intermediary's interest in the client's activity, whether there may be any conflict of interest, and in terms of the information surrounding the investment product the client may be interested in, i.e. corporate information and execution information. Such information asymmetries, in the absence of regulation, may result in the intermediary abusing the superior position of knowledge. For example, an intermediary may make "buy" recommendations to a client where it has also underwritten a particular securities issue. As to fraud, in the absence of regulation, breaches of trust could occur. For example, intermediaries could claim commission for non-existent trades. Therefore, regulation is provided to ensure the integrity of client order-handling and

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the accounts and receipts of the intermediary. It may be argued that intermediaries could be relied on to self-regulate as they would protect their own reputations. (Choi, 2000) Reputational capital is important to intermediaries and it may be argued that the intermediaries' own drive towards reputational protection acts as a form of control on abusive behaviour against clients. However, research reveals that reputational pressures alone do not prevent wrong-doing. (Shell, 1991)

Intermediary regulation is necessary for investor protection and ensuring that intermediaries provide an honest, fair and competent standard of service. Besides investor protection, such regulation could also achieve the wider benefit of avoiding the "lemons situation" which refers to a situation where investors are left to discern for themselves which lemons are good, and which are bad, and when they cannot tell the difference, they may become risk averse and withdraw capital. (Pacces, 2000).

The regulation of agency problems in client-intermediary relationships is an important foundation for investor confidence and investment activity. Part 2 of this paper briefly discusses the rise of the Internet as a form of "disintermediation", and examines if the Internet age has removed the need for the principal-agent model for intermediary regulation. Part 3 queries as to how interactions over the Internet may put into question the traditional assumptions in principal-agent regulation. The limitation of words upon this paper makes it impossible to address in detail all aspects of intermediary activity and this paper will make general arguments with specific examples drawn from a selected discussion of intermediary activity. Part 4 then looks into the recently enacted Markets in Financial Instruments Directive ("MIFID" 2004/39/EC, OJ 2004 L145/1) and examines whether the MIFID addresses these modalities and provides for appropriate regulation in the examples raised.

2. The Internet Age, Disintermediation and the Relevance of Principal-Agent Models in Client-Intermediary Relationships

With the rise of the Internet and increasing access to it, hypotheses have been made as to the ultimate disintermediation in many transactions. This is largely because intermediation imposes extra layers of cost (Benjamin and Wigand, 1995) and if the Internet levels the playing field for many market actors, then market actors may seek to avoid intermediary costs by using the Internet as a new means of reaching ultimate suppliers and buyers. (Peake, 2001)

Empirical research has pointed out that the existence of the Internet itself and widened information access does not mean that intermediaries are not needed. Empirical research points out that markets cannot be fully automated as trade execution is a discretionary decision and not capable of complete automation (Picot et al, 1995). Thus, intermediaries remain relevant to the discretionary aspects of securities trading. The extent of intermediary relevance to transactions depends on what kind of function or functions intermediaries serve. As intermediaries often serve a bundle of functions (Schmitz (2000), Sarkar, Butler and Steinfield (1995) and Giaglis, Klien and O'Keefe (2002)), and those functions remain relevant to electronic transactions, intermediaries simply evolve to adapt to the Internet medium ("reintermediation"), or create new functions based on the Internet medium ("cyberintermediation").

In terms of investment services, there are 3 aspects of intermediation based on the typology of intermediary services set out by Schmitz. He argues that intermediaries could offer a bundle of 3 types of services, namely, to hold inventory for immediate execution of trades, second, to gather information and tailor advice to client's specific needs, and third, to provide familiarity as a counterparty in execution of transactions, in order to establish a reputation so as to facilitate trading confidence and trade.

This typology, although not used specifically to describe the investment intermediary, provides a good overview of the investment intermediary's services to his client. The Internet allows electronic market-places to be set up so that investors could "meet" sellers and buyers directly (Coffee, 1997); and the Internet is a repository of much information that investors can retrieve and use to inform investment decisions. (Langevoort, 1985) However, these opportunities for the investor do not immediately translate into discontinuation of the need for an intermediary. Professor Coffee mentioned that an intermediary may provide a buffer against counterparty risk and guarantees execution of trade once an order is put in. An electronic venue for meeting other buyers and sellers does not give such a guarantee. Intermediaries also mediate risks associated with settlement and clearing after trades. Besides, market-making intermediaries provide continuous liquidity, whereas electronic market-places may not be able to find the perfect match for an order that quickly. In this respect, the "inventory" function of the intermediary is likely to be needed, and it is unlikely that investors would discontinue the use of intermediaries altogether.

Second, many investors look to intermediaries to organise the multitude of corporate information available on potential investments, and to give advice on suitable investments. This has been argued to apply not only to retail type investors (Clemons and Hitt, 2000) but also to sophisticated investors (Langevoort, 1996). It has been opined that sophisticated investors such as pension funds and unit trusts deliberately refrain from amassing too much knowledge of corporate information, as this may tip them over into insider dealing liability if they are found to have traded on certain corporate information (Schmitz, 2000). The widened access to information has actually given rise to more opportunities for investment intermediaries to organise information and give tailored advice to investors. This aspect of intermediation is again unlikely to be overtaken by Internet developments.

Finally, Schmitz opines that intermediaries provide a “confidence” function as a familiar counterparty in repeated trades. Where buyers and sellers transact directly over an electronic market-place, there is an issue of party credibility and verifiability. Intermediaries who transact with many principals create repeated trades, and build up a reputation. Such a reputation facilitates trade, and improves market confidence in the market concerned.

The investment intermediary is unlikely to be effaced by the Internet. However, what is pertinent for the regulation of these intermediaries is whether the same principal-agent assumptions underlying regulation remain relevant to intermediary activities over the Internet.

3. New Modalities in the Principal-Agent Relationship in the Internet Age

Part 2 establishes the argument that intermediaries are likely to remain important to securities investors despite disintermediation hypotheses that have arisen since the Internet revolution. However, the fact that these intermediaries remain providers of intermediation service does not of itself warrant regulation. In this Part, I will examine the traditional assumptions behind the principal-agent model to see if these assumptions still apply to the provision of intermediary services over the Internet.

3.1 Information Asymmetry

One of the traditional assumptions of intermediary regulation based on the principal-agent model is that of information asymmetry between the agent and principal, as briefly described in Part 2.

In terms of information asymmetry, it may be argued that as the Internet has provided opportunities to inform on a much wider scale than ever before, the Internet may have levelled the asymmetry and regulation based on this rationale may have to be rethought. However, information does not translate into knowledge if disparate sources of information may not be easily organized into an intelligible whole, or if too much information causes an information overload for investors (Paredes, 2003). Therefore, the availability of more information than ever before does not of itself mean that the investor should not suffer from information asymmetry. Further, even if information is made available, it may not be understood by the investor, and an investor may need expert advice to relate that information to his own investment appetite and circumstances, to discern if the investment is suitable for him. Investors may thus seek intermediaries out to make sense of the information, and to ascertain suitability of the investment. It may however be argued that as long as the resources for making informed investments are available, especially on the Internet, the information asymmetry technically does not exist, and if investors choose not to take responsibility for their investment decisions and wish to delegate diligence to an intermediary, this should be dealt with in the private law of contract should any problems occur. However, the retail investor is generally assumed to be much less sophisticated than the intermediary, and where parties are not equal in contract, there is room for regulation to address any imbalance that may result in abuse or externalities. Hence, the protection of an investor is arguably based on the inequality in competence between the intermediary and the client, and not based on a delegation of due diligence. Besides, much information out in the Internet may be generated by noise trading, which provides signals, but the reliability of those signals may be indiscernible except to practised professionals. (Fox, 2004).

Next, limited asymmetry may still exist in terms of the intermediary’s conflict of interest with his client principal, and hence, some regulation on conflict of interest disclosure is arguably warranted. Information asymmetry is likely to remain between the investor and client as the Internet is arguably unlikely to empower all retail investors with information to the same extent as an intermediary could be. However, the nature of information asymmetry changes over the Internet. In the traditional principal-agent model, the assumption that is made is that the principal knows much less and is able to know much less than the agent intermediary who is

a professional in investment services. The agent can thus take advantage of the principal in carrying out agency duties such as execution of trades. In the Internet age, two phenomena take place to change the nature of information asymmetry between clients and intermediaries. The first is the unbundling of intermediary functions, and the second is the transience of client-intermediary relationships. These two phenomena will be discussed in the following sub-Parts, and how they affect client-intermediary relationships. However, the main point that this Part concludes with is that, although the Internet brings about unbundling of intermediary services and transient client-intermediary relationships, it is only the traditional assumptions of the principal-agent dynamics that may be questioned; the broad principle of principal-agent regulation arguably remains.

3.2 Unbundling of Intermediary Functions and Transience

“Unbundling” means that the traditional notion of intermediaries providing a package of services to a client is now being unpacked. Securities intermediaries traditionally offer a package of services including investment advice, portfolio management, execution and finalization of transactions and custodianship of client moneys and assets. Between investors buying and selling shares, there are actually two intermediaries, the marketplace and the broker or broker-dealer who brings orders to the marketplace. Primary offers of securities is slightly different as the underwriter is often the only intermediary between the issuer and investor, and for the purposes of discussing regulation of brokers and broker/dealers, the investment activity in the primary market will not be discussed in this article.

The unbundling of intermediary services has resulted in the unpacking of all intermediary functions over the Internet. This means that intermediary functions are no longer necessarily provided as a traditional package, but may be provided as standalone services or services in new combinations that not have hitherto existed. Two opposite but not conflicting phenomena have arisen. One is that intermediaries such as brokers and broker-dealers have expanded into providing the marketplace for securities themselves. Many brokers and broker-dealers have established electronic trading networks as market-places outside traditional stock exchanges. These marketplaces are referred to as “Alternative Trading Systems” or “ATSs” in the US, and “Multilateral Trading Facilities” or “MTFs” in the Markets and Financial Instruments Directive (“MIFID”). The internal books of large broker firms are also a market-place in itself as brokers execute orders by cancelling them on their internal books, a practice referred to as “internalization”.

The other major new modality, quite opposite the “expansion” of services, is the “disaggregation” of services. Broker services such as execution and advice can become separated and unpacked as different types of services provided by different online intermediaries. Online brokers who perform execution only services may charge very low commissions and are very competitive, commonly referred to as “discount brokers”. (Rice, 1999)

Where broker-dealers have aggregated with the provision of market services, the increase in the bundle of intermediary services provided may warrant a continuation of agency regulation based on information asymmetry, or even increased regulation. The rolling of brokerage into operation of a marketplace has rightly attracted regulators’ attention both in the US and the EU. This means that the broad principal-agent rationale for regulating intermediaries continue to be relevant. However, are the traditional assumptions in the principal-agent model still valid? The traditional assumption of information asymmetry underlying the principal-agent model is still valid in the relationship between a client and an ATS/MTF that is both a broker and a market. In fact, because the intermediary is now both a broker and a market, it possibly has a greater level of information superiority, as it may possess superior information not only about the performance of a stock, but also the orders on the market, and the intermediaries who are operating on the market. In such a case, it seems that more regulation to address the information asymmetry is necessary. The MIFID, as discussed in Part 4 has responded to that need by regulating the disclosure functions of broker/MTFs pertaining to both their agency services and market services.

Where there is disaggregation of intermediary services, the question arises as to whether certain traditional assumptions of the principal-agent model still apply. For example, where an online intermediary provides a limited service such as execution only, and a client “buys” that service, the amount of information between client and intermediary may be confined to the execution order and may be limited, in the absence of any regulation on information disclosure. It was opined that in 1977 that:

the relationship between investment adviser and investor is neither casual nor short term. (Salmanowitz ,1977) However, in an online context, the traditional long term relationship between client and intermediary may be easily replaced with transactional and sporadic interaction between client and intermediary. In an environment where intermediary services are disaggregated, service provision may become limited and short-term. The

intermediary and client may not actually *know* each other well, and there is arguably a bilateral decrease in information exchange, and hence, a bilateral increase in information asymmetry. However, for the purpose of the limited online service, it may arguably not be necessary for a large amount of information exchange to take place. In such a case, it may be arguable as to whether the traditional assumption of regulation due to information asymmetry is still relevant to this principal-agent model. Disaggregation may also cause greater transience in client-intermediary relationships. Transience refers to the situation where clients may have limited and short term relationships with online intermediaries, such as for one-off execution services, or one-off information provision services. The reliance by the client on the intermediary is limited, and the relationship may expire very quickly. Transience also affects to what extent the fiduciary nature of the client-intermediary relationship remains a valid assumption of the principal-agent model of regulation, as transience represents limited reliance by a client on his intermediary.

On the other hand, it may be argued that the increased information asymmetry is a gap for regulation to fill. The MIFID has responded with increased and not decreased regulation of intermediaries in its principal Directive and Commission legislation supplemental to the Directive (MIFID Commission Regulation No 1287/2006, OJ 2006 L241/1 and MIFID Commission Directive 2006/73/EC OJ 2006 L241/26). The MIFID and Commission Directive prescribe in copious detail, the type and extent of information an intermediary should provide to his client, from general information on its products, services, the risks of investments and its charges, to specific information on contractual terms and its conflict of interest policy, and custodianship policy. This is flanked by the Distance Marketing Directive (2002/65/EC, OJ 2002 L271/16) which deals with compulsory disclosure of information pertaining to the identity, payment and rights of the consumer of financial services over distance selling, which includes online services. These comprehensive prescriptions for disclosure take on two characteristics. One, the general disclosure requirements are intended to make up for the increased depersonalization between clients and intermediaries, and are intended to provide enough knowledge for a client before s/he chooses to go with a particular intermediary. But the staggering amount of detail the MIFID Commission Directive requires intermediaries to disclose (Articles 27-33) is tediously prescriptive, and an intermediary offering any service is likely to labour over checking off that an item has been disclosed, rather than building up a wealth of communication with a client. Second, the specific disclosure requirements (Article 19 MIFID, and Article 29, MIFID Commission Directive and particularly in the Distance Marketing Directive) are transaction-based and are different in nature from the accumulated personal relationship between the traditional intermediary and client. There seems to be a change in the interaction modalities between client and intermediary from a type of relationship based on long term confidence to a more contractual and transaction-based relationship. The regulatory policy indicates that there is a preference for regulation to supplant the freedom of contract between client and intermediary, so that regulation itself provides the template for the client-intermediary relationship. However, a contrary policy may also be workable, i.e. allowing freedom of contract in an online environment, and reducing the amount of fiduciary regulation in the client-intermediary relationship. This will be discussed in Part 4.

4. Selected Discussion of the MIFID's Relevance to Intermediary Regulation On the Internet

4.1 Functional Regulation of MTFs

One of the major developments for online intermediaries in the unbundling process is the aggregation of brokerage and market services into a Multilateral Trading Facility (MTF) or online marketplace.

Before the MIFID, the MTF is regulated mainly as a broker, similar to the approach taken under the US Regulation ATS. This regulatory approach has largely been criticized to be insufficiently cognizant of the unique characteristics of an ATS, and the attempts to pigeonhole ATSS into enhanced brokers or exchanges merely delay the acceptance of new understandings of the ATS. (Collins, 2002), Gallagher (1998) The MIFID approach seems to be an improvement over the bifurcated approach in the US, as it addresses MTF functions on their own. Whether it is a broker firm operating an MTF or any other market operator, the regulation of the functions of the MTF is the same.

The MIFID regulates the following functions of an MTF:

a) Operational and Administrative Arrangements

Article 13 of the MIFID requires every MTF to have sound, effective and regular operational and administrative procedures that deal with client assets, money and information, as well as in relational dealings

with clients such as the prevention of conflicts of interest. Specific measures fleshing out what “sound, effective and regular” mean have been provided for in the Commission Directive supplemental to MIFID, and these include risk management, a compliance officer and systems, processes for internal audit, and processes for identifying and preventing conflicts of interest from arising (Articles 5-8, 11-12, and 21-26).

b) Operational Rules for Market Management

Articles 14 and 26 of the MIFID provide that the MTF must have in place rules and systems that would allow it to conduct a marketplace. Article 14 deals with the establishment of fair, orderly and transparent rules and systems for trading priorities and execution, as well as market access (supplemented by Articles 35-39 of the Commission Regulation pursuant to MIFID). MTFs are also required to inform clients clearly as to how transactions may be cleared and settled. Article 26 deals with supervisory systems the MTF must put in place in order to ensure orderly trading, absence of market abuse, and compliance with its rules by its user clients.

c) Price Transparency. Articles 29 and 30 deal with price transparency services that the MTF may provide in its marketplace. Hitherto unregulated, price transparency is a new area for EU securities regulation. Article 29 requires MTFs to provide a minimum level of pre-trade transparency, i.e. current bid and offer prices and the depth of trading at these prices (at 5 best bids and offers unless market is an auction driven system or uses other price discovery algorithms, see Article 17, MIFID Commission Regulation). Article 30 of the MIFID and Article 27 of Commission Regulation deal with post-trade transparency, and MTFs are to make public a list of prescribed information including the price, volume and time of transactions executed in its systems as close to real-time as possible (defined as 3 minutes from close of trade). Although many leading exchanges provide pre and post-trade transparency services above these minimum levels (Chiu ,2006), these requirements are likely to provide a minimum standard of price disclosure across MTFs.

The expanded information disclosure requirements placed on MTFs, such as price transparency, seems to indicate that regulation has been adapted to respond to the changing nature of the broker/MTF, in particular where information asymmetry may increase between a client and MTF intermediary, in such a way that the MTF is informationally much more powerful than the client.

4.2 Disaggregated Intermediation and Best Execution

As discussed, disaggregated services of intermediation over the Internet may produce limited and short term client-intermediary relationships. With arguably less bilateral information exchange between client and intermediary, there is greater information asymmetry both ways. However, this is balanced against the possibility of less reliance and transient relationships with intermediaries. As such, do traditional notions of fiduciary duties apply to the online intermediary who performs a limited service?

Most of the broker duties laid down in the MIFID are rooted in traditional fiduciary duties (Facciolo (2005)). The duty to know your client, provide suitable investment advice (Article 19), best execution (Article 21), and fair and orderly handling of orders (Article 22) are traditional aspects of a broker’s fiduciary duty to his client. However, the MIFID does take into account the possibility of online discount brokers, and specifies in Article 19 that where a broker is limited to execution only, suitability obligations are not triggered. However, the MIFID does not actually address disaggregation of intermediary services much apart from the above example. In fact, the MIFID Commission Directive reinforces the impression that the MIFID is intended to buttress traditional broker duties and make them more stringent. I will proceed to argue that the fiduciary standard of best execution, rooted in the traditional offline context, is inappropriate for online transactions. This discussion only focuses on best execution, as the limitations imposed on this paper prevent me from addressing other traditional broker duties such as suitability, which are addressed in a longer paper that is forthcoming.

How may a duty of best execution apply to an online context that is different from a traditional context? “Best execution” is a highly indeterminable concept as it is largely rooted in client-intermediary communications, client expectations and instructions, and an intermediary’s discretion based on his available resources. It is a highly morphable benchmark depending on the nature of the contractual relations between the client and intermediary (Macey and O’Hara ,1997). It has been opined that price is not necessarily the benchmark for best execution (Facciolo ,2005), and the MIFID recognizes that other criteria such as speed, certainty and volume matter as well for some investors, although it uses price as the benchmark where retail investors are concerned (Article 44(3), MIFID Commission Directive). In an online context, it may be argued that depersonalization of communication between the client and intermediary makes it more difficult to determine best execution (Furey and Kiesewetter ,2001). One, the lack of personal communication between client and intermediary allows for gaps in their contractual relations. In the online context, client instructions

may become standardized, and opportunities arise for the intermediary to interpret what he may consider to be best execution for the client. Intermediaries may also use standard algorithms to route execution instructions. For example, Selftrade.co.uk and Halifax Share Dealing claim that they will route orders in such a way as to better the price offered on the London Stock Exchange, but they do not disclose their routing centers or processes. How should such processes be judged against a requirement of “best execution”? The MIFID Commission Directive responds to this by adopting a twin approach. First, by prescribing copious detail on information disclosure, so that information asymmetry between client and intermediary are levelled to a standardized platform, and second, by a client categorisation approach. Clients are classified into retail, professional and eligible counterparties (against whom broker duties in MIFID may not apply, see Article 28). For retail clients, best price is assumed to be best execution. In sum, the MIFID regulates best execution by adopting standardized approaches to put clients and intermediaries at a standard level of prescribed mandatory knowledge, and pigeonholing investors so that uniform yardsticks can be prescribed to replace the freedom of contract between client and intermediary. It is arguable that in a depersonalization context online, such an approach may provide the best standard “contract” between client and intermediary, and such a contract is akin to a public good. However, it may also be arguable that the opposite conclusion is sound, i.e. despite depersonalization in an online context, clients and intermediaries are able to contract for execution in their best interests because of the variety of contractual choice that may exist absent regulation.

Easterbrook and Fischel (1993) have argued that the contract between principals and agents is incomplete as neither can predict the contingencies that may arise. Hence, the fiduciary obligation is imposed in law to fill in the gaps of the hypothetical bargain. It may be argued that in an online context, the same contingent gaps do not arguably exist for each online contract made between clients and intermediaries. Clients have the choice to surf for different combinations of contractual terms, and hence, the “gaps” that may exist for different contracts may be different, making it impossible for regulation to provide a set of standard terms to fill in the gap. Thus, “best execution”, as standardised under the MIFID, may become outmoded in an online context where choice increases multifold. It may however be argued that the fiduciary duty of best execution is still necessary as the agent voluntarily assumes responsibility towards the principal (DeMott,1988). However, the bilateral information asymmetry and website disclaimers often make an investor aware of the limitations of the online provider, thus having the effect of reducing reliance. Hence, online providers may go in the opposite direction of voluntary assumption. It cannot arguably be assumed that fiduciary duties such as the traditional suitability and best execution requirements should remain for online transactions. Further, a standard set of regulatory norms may also stifle innovation in contractual devices that may be evolved to meet investor needs. It may also be argued that the standard set of fiduciary duties imposed on intermediaries, if applicable to online intermediaries, may also cause moral hazard to investors, as investors can rest on the laurels of protective regulation while making careless choices online, despite there being much more information and choice.

Online intermediaries may specify the policies and processes of their execution, and clients are free to surf and choose the one that suits them best (Kobayashi ,2005). In such a case, “best execution” can arguably be contractually agreed to be at the standard contracted for. For example, Interactivebrokers.co.uk allows even greater autonomy on the part of investors to enter up to 30 types of order online, based on price data that is 15 minutes delayed, and so it is up to the client to decide if the service sufficiently meets his needs. The online platform arguably provides myriad choices for investors to decide on, and it may be appropriate to move away from the regulatory standard for best execution, and leave it to be regulated by the private law of contract. However, that is not to say that MIFID should remove fiduciary regulation of execution altogether. Other problems regarding execution in an online context occur more frequently, such as whether a client has properly consented to a certain execution. Experience in the US shows that even where online intermediaries have standard form agreements with their clients, overtrading of clients’ account or imprudent trading may still occur (see *Desmond v Ameritrade*, NASD Arb. No. 98-04397, 2000 NASD Arb. LEXIS 457 (Jan. 13, 2000) and online intermediaries need to be disciplined and investors need redress in these situations. Regulation may well concentrate more on processes for consent to be ascertained before each trade, or before significant trades, if a global instruction has been given. The MIFID and Distance Marketing of Financial Services Directive emphasize identity verification and information disclosure before any contract is entered into, but more needs to be done for online investors to know how post-contract relations may be managed, i.e. when they are consenting to trade and how continuous disclosure between client and intermediary could be sustained over repeated trades. The MIFID arguably takes care of some post-contractual conduct such as reporting to clients, keeping records and custodianship (Article 13 of the MIFID, and Articles 7 and 8 of the Commission

Directive), but insufficient attention is paid to ongoing activity between client and intermediary, and how a client may exercise control to prevent loss.

If an intermediary engages in trades, especially repeated trades which he may believe to be in the client's favour, but contain inherent risk for the client, how should the client be protected under law? In an online context, many online brokers boast of being able to provide brokerage services for the client at one click and with full automation. This actually reduces the client's control over his trading account. Even if a client may have earlier accepted the possibility of multiple trades and margin trading, a client may not know to what extent he would actually commit himself if he were not in full control of the trades. However, the whole point of delegating to an intermediary is so that the principal need not exercise total control and may be able to trust the intermediary. In this respect of intermediary discretion, it is arguable that neither the MIFID nor the Distance Marketing Directive have provided for the agency issues arising out of online agents' discretionary use of client's account, and the implications of certain ongoing activity and automated processes. Regulation is needed to ensure the transparency and accountability of intermediary discretion in using the client's account. Perhaps a fiduciary standard of conduct should be imposed on intermediaries to manage clients' trades with responsibility, transparency and accountability, and in particular to ensure that automated processes are reviewed to see that they constantly meet clients' needs. Transparency and accountability may be achieved by providing more specific alerts to clients, in addition to the periodic reports and late disclosure of account depletion found in the Commission Directive (Articles 40-42). Regulation may also provide for client's rights to veto certain trades ex post, within reasonableness. Regulation may also be needed to combat any unfair exclusion or global terms that vest excessive discretion in the agent. These are not addressed in either the MIFID or the Distance Marketing Directive.

5. Padding up the Distance Selling Regulation?

Although the MIFID has responded to the new creation of the MTF and has provided a set of functional regulation, the MIFID has not responded sufficiently to disaggregation of intermediary services online and the implications upon traditional fiduciary duties. It may be appropriate for regulation to be reduced in traditional areas such as best execution in an online context, so that contractual arrangements may provide for the client investors' needs. However, online relationships with an intermediary raise problems regarding ongoing communication between clients and intermediaries, and regulation should help in this to fill in the contractual gaps. One type of communication deficit that may be regulated is how to ascertain client consent for trading, especially in repeated trades. Online client-intermediary relationships pose problems especially in ascertaining consent for trades and churning, and MIFID regulation is weaker in addressing these relational aspects of online dynamics. Perhaps this can be addressed by padding up the Distance Marketing of Financial Services Directive, to include unfair contractual practices, in due course.

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