

Economic Analysis of Law Review

The Case of Deregulation of Investment Advice Services in Mexico: A new face of regulation

Em Defesa da Desregulamentação dos Serviços de Consultoria Financeira no México: uma nova face da regulação

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RESUMEN

Los reguladores del mercado de valores continuamente enfrentan diversas disyuntivas, por ejemplo, entre promover la eficiencia del mercado o la protección a los inversionistas, o entre fomentar la innovación o reducir los riesgos de productos financieros. La importancia del mercado de valores en una economía es indudable puesto que la inversión es vital para el crecimiento, desarrollo y fortaleza de la economía; sin embargo, después de haberse detonado una crisis financiera internacional, una mayor regulación y supervisión son exigidas a las autoridades financieras. No obstante, un marco legal libre de directivas estatales, incluso a través de “normas no coercibles”, pueden lograr mayor eficiencia en el mercado. El análisis económico de la desregulación de los servicios de asesoría de inversión en México, la cual se efectuó con la entrada en vigor de la actual Ley del Mercado de Valores en 2006, demuestra que un marco regulatorio puede influenciar la conducta de los individuos sin un carácter directivo ni coercible y lograr resultados positivos en el bienestar social, en términos de promoción de la competencia y de protección al inversionista.

Palabras clave: Regulación, Asesores de Inversión, Servicios Financieros, Protección al Inversionista.

JEL: K20, K22.

ABSTRACT

Regulators of securities markets continuously face different trade-offs, for instance, between market efficiency and investor protection, or innovation and reduction of risks of financial products. The importance of securities markets in an economy is undeniable, due to the fact that investment is vital to the growth, development and strength of economy; however, after booming an international financial crisis, more regulation and supervision are demanded to financial authorities. Nevertheless, a legal framework free of state directives, inclusively through “non-enforceable rules”, can achieve better efficiency in the market. The economic analysis of the deregulation of investment advice services in Mexico, which was made when the Mexican Securities Market Law came into force in 2006, proves that a regulatory framework can influence the actors’ behavior without a directive and enforced character, and achieve positives outcomes in social welfare, in terms of promoting competition and investor protection.

Keywords: Regulation, Investment Advisors, Financial Services, Investor Protection.

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1. Introduction

Nowadays, after booming an international financial crisis, more regulation and supervision over financial intermediaries are demanded to financial authorities around the world (Goodhart, et al., 1998, p. 63). However, those claims become less loud when the consequences of overregulation are recalled (Goodhart, et al., 1998, p. 190; Lindsey, 1999, pp. 309-311).

Regulation can provide protection and lower risks, but it also generates costs (Finsinger, 1996, p. 243; Goodhart, et al., 1998, p. 190) and is able to reduce competition and innovation (Llewellyn, 1986, pp. 10, 12, 29, 49; Lindsey, 1999, pp. 307-311; Goodhart, et al., 1998, p. 192). In one or another way, consumers pay for those factors at the end. Furthermore, excessive regulation can affect the other side of securities market. Investment is vital to the growth, development and strength of economies (Lindsey, 1999, pp. 295, 298), even though it always involves risk (Goodhart, et al., 1998, pp. 14-15, 192).

The importance of securities markets in an economy is undeniable (Lindsey, 1999, p. 295). Inclusively, investment has become a mechanism for saving as a result of the phenomenon known as “popularization of the investments” (Bombín, 2008, p. 221). The proliferation of mutual funds and other collective investments schemes has led to securities markets have become central to individual wealth and retirement planning (IOSCO’s Principles, p. 1). Therefore, the regulatory trends aim to provide accurate levels of protection to investors to promote investment (Lindsey, 1999, pp. 297-307) and thus, to increase both private and social welfare.

However, strong government intervention does not imply more investor protection (Lindsey, 1999, p. 297). Inclusively, a legal framework free of a directive state intervention can provide sufficient incentives to promote such protection without dismissing the potential benefits of investment. This is the general hypothesis that this work aims to prove through the economic analysis of the deregulation of investment advice services in Mexico.

The current Mexican Securities Market Law (SML) came into force in June 2006. Among its innovations, there was a substantial amendment in the investment advisors legal framework. This reform led to two types of investment advisors. On the one hand, there are the common financial intermediaries of the securities market, who are authorized, regulated, supervised and sanctioned by the National Banking and Securities Commission (CNBV). On the other hand, there are the professional investment advisors, who were deregulated up to the point of being totally free of government intervention. Thus, there is a regulatory disparity between the two types of investment advisors.

In the economic point of view, the efficiency of the market is the final goal that regulation –or deregulation– has to follow, under the assumption that efficiency means maximizing social welfare². Therefore, the first aim of this study is whether the regulatory disparity between the two kinds of investment advisors in Mexico is economically justified. In a parallel way, this first approach will reveal if investment advice services require a regulatory intervention under the economic sight.

² In the economic theory, social welfare is the aggregate of all individual welfare. Hence, social efficiency – allocative efficiency or Pareto improvement criteria– means a situation in which scarce resources are allocated in a way that sees at least one individual increases his utility with nobody else made worse off, so that total utility increases within the society. See Polinsky (1989, p. 7); Coleman (1982, pp. 83-84, 86); Ogus (2006, pp. 25-31; 1994, pp. 23-25).

Regulation, in economic terms, has been traditionally identified as a state intervention (Selznick, 1985, p. 363) to correct deficiencies in the operation of the market which would not occur without such intervention (Ogus, 1998.a, p. 75; 1994, pp. 1-3, 29-46). However, a new trend among scholars has defined regulation in a broad sense, such as “the intentional activity of attempting to control, order, or influence the behaviour of others” (Black, 2002, p. 1), regardless the existence of directive rules or government intervention. Though, this new view keeps to the basic requirements of regulation: “the setting of, process for monitoring compliance with and mechanism for enforcing standards” (Parker, et al., 2004, p. 1).

Due to the fact that the Mexican legal system follows a *civil law* tradition in which legal rules need to be written in order to be enforced, the present study will be based on the broad definition of regulation (Black, 2004, p. 34). On this basis, the deregulation of Mexican investment advisors should not be seen as making the profession “free of rules”, but as an act leading to less government intervention (Parker, et al., 2004, pp. 2, 4-5).

Nevertheless, several factors play in the market efficiency and regulation is only one of them (Black, 1997, pp. 248-249; Quinn, 1999, pp. 313-317). The effectiveness of regulation, as an instrument of social wealth-maximization (Ogus, 2006, p. 99), cannot be determined without analysing how legal rules play with *informal institutions*³. Therefore, this analysis will deal with a second target related to the accuracy of the Mexican investment advisors’ regulation to achieve efficient outcomes in the market of their services, considering some of those *informal institutions*.

Finally, a third factor will be showed by this study which consists of the signalling role that regulation can also play. A regulatory framework can influence the actors’ behaviour – producers or consumers– without a directive and enforced character and achieve efficient outcomes in the market, such as competition and consumer protection. Thus, the deregulation of investment advice services in Mexico comes to show a new role of regulation.

In sum, the analysis of (i) the economic justification of whether investment advisors’ regulation is necessary, (ii) the efficient outcomes of that regulation can achieve considering some *informal institutions* and (iii) the signalling role of regulation, will prove that a legal framework free of a directive state intervention and non-enforceable rules can provide sufficient incentives to promote investor protection in social efficient terms.

Accordingly, the following study is a positive and functional economic analysis of law which would be developed to ascertain whether regulation –or deregulation– pursues social efficiency considering the influence of some *informal institutions*, such as reputation or branding. Therefore, this work does not have the scope to find the “policy reversal” causes over investment advisors⁴, to provide a normative criterion or to defend efficiency as the final goal.

In order to set out a reference point about the efficiency of the current Mexican investment advisors’ legal framework, the following study explores –under the light of the Economic Public Interest Theory of Regulation and the Forms of Social Regulation– the previous Mexican regulation of investment advice services, as well as the international trends among the countries that are part of the European Union and the International Organisation of Securities Commissions (IOSCO). Hence, implicitly a positive comparative law and economics analysis⁵

³ *Informal institutions*, according to Helmke and Levitsky, are those created, communicated and enforced outside of officially sanctioned channels. These informal institutions can also affect the incentives or expectations of the actors and in some instances, informal incentives trump the formal ones, strengthen or complement them. See Helmke and Levitsky (2004, pp. 725-734).

⁴ For details see Hood (1994, pp. 3-18).

⁵ For details about Comparative Law and Economics see Mattei, et al. (1999).

will be developed, in which those regulatory alternatives will be compared with the economic models of the law, built by Law and Economics field.

Through this work, having set of the meaning of investment advice services, the special characteristic of the Mexican deregulation of investment advisor will be pointed out under the Mexican legal system and in comparison with the international regulatory practices (Section 2). Then, under the Economic Public Interest Theory of Regulation it will be analysed whether this deregulation and its disparity from financial intermediaries' legal framework is economically justified (Section 3). Furthermore, by analysing different Forms of Social Regulation used in the Mexican context and at the international level, it will be determined the effectiveness level of the Mexican case to achieve socially efficient outcomes (Section 4). This will lead to analyse the signalling role of the SML (Section E). Finally, the conclusion will be given (Section 5).

2. Investment Advice Services, the Mexican Providers and their (De)regulation

Rational investors face a complex, wide-ranging set of financial products so that, in addition with their usually limited expertise in investment, it might be necessary for them to obtain assistance from investment analysis experts. In other words, investor utility could increase by exploiting scale economies in information acquisition (Blüthgen, et al., 2009, pp. 1-5). There is some evidence which suggests that investors who follow the advice of or delegate investment decisions to their investment advisors have better portfolios and obtain greater gains than amateur investors who manage their investment without resorting to expert advice (Gerhardt and Hackethal, 2009), pp. 3, 18-19, 23). Furthermore, other studies support that the cost of inefficient asset allocation has reached ten billion euros per year (Rehberg, 2009). Herein is the importance of investment advice services.

The different jurisdictions around the world have built their respective regulatory system around the providers of investment advice. However, the Mexican case highlights a marked difference in the way that international trends deal with investment advisors. Therefore, in order to show why the Mexican case is special, it is necessary to define what has been understood as investment advice services by financial regulators and who the providers of these sorts of services are under the Mexican Law and at the international level. For these purposes, the prescriptions of the SML, the European Legislation –in particular the Markets in Financial Instruments Directives (MiFID)⁶– and the principles and recommendations enacted by IOSCO will be considered.

2.1. What Investment Advice Services Mean

Among securities regulators, investment advice services have been understood as professional services of personal recommendations to engage in transactions with securities. For instance, the MiFID defines investment advice as “the provision of personal recommendations⁷ to a client, either upon its request or at the initiative of the investment firm, in respect of one or

⁶ The Markets in Financial Instruments Directive (MiFID) include two kinds of directives: the Directive 2004/39/EC and the Directive 2006/73/EC. For more details, see Bombín (2008, pp. 219-221).

⁷ Investment recommendations issued through public distribution channels or released to the public in general are not considered investment advice services. Article 52, last paragraph of the Directive 2006/73/EC, and Mexican Regulatory Provisions to Elaborate Investment Recommendations.

more transactions relating to financial instruments”⁸. On the other hand, according to IOSCO investment advice services are advising others regarding the value of securities or the advisability of investing in, purchasing or selling securities (IOSCO’s Principles, p. 39). The Mexican legislation also includes investment guidance, analysis and recommendations into investment advice services⁹.

In addition to personal investment guidance, the SML includes portfolio management services as a part of investment advice services, which involve taking investment decisions on another party’s behalf¹⁰. Therefore, in this work, both portfolio management and investment advice services should be understood as investment advice services as a whole, unless there is an explicit distinction.

It is important to point out that investment advice services are legally relevant only when they are provided on a professional basis. This means when the regular occupation or business of providers is the provision of such services. A solely investment advice or a particular proxy to make investment decisions granted to a person whose regular occupation is not to provide investment advice is not prohibited but neither constrained by the regulatory provisions of the securities market¹¹.

2.2.The Mexican Providers: Financial Intermediaries and Investment Advisors

The SML recognizes professional providers of investment advice services to financial intermediaries and investment advisors¹². On the one hand, the financial intermediaries are financial institutions¹³, who are exclusively able to develop intermediary activities in the Mexican public securities market¹⁴. They are authorized, regulated and supervised by the CNBV¹⁵ and, as financial institutions, they have control of money or assets belonging to customers¹⁶.

⁸ Article 4.1(4) of the Directive 2004/39/EC, and article 52 of the Directive 2006/73/EC.

⁹ Article 225 of the SML.

¹⁰ *Ibid.*

¹¹ IOSCO’s Principles, p. 39; seventh whereas and article 2.1(c), 2.1(j), 4.1(1) of the Directive 2004/39/EC; number (5) of the Section A, *Investment services and activities*, of the Annex I, of the Directive 2004/39/EC, and Article 225 of the SML.

¹² Articles 171(IX), 171(X) and 225 of the SML.

¹³ According to the SML, market intermediaries are brokerage firms, banks, investment fund managers, pension fund managers and investment funds retailers (article 113 of the SML). However, this study will be focused on the regime of brokerage firms (the main securities market intermediary in Mexico) because of three reasons. First, investment fund managers and investment funds retailers have a delimited goal or specific securities transactions. Also, the main objective of the banks could not be intermediary activities in the securities markets, though they are allowed to provide them. Second, brokerage firms and banks are exclusively allowed to execute operations in the Mexican public debt securities market, but only can brokerage firms transact in the Mexican Stock Exchange. Third, regulation of brokerage firms’ investment advice services is the most comprehensive about the duties that financial intermediaries have to fulfill. In other words, regulation of brokerage firms is the general regime of investment advice services and financial intermediaries have exemptions or modalities to that general regime, according to their specific objectives. Articles 246 and 257 of the SML; 39 and 40 of the Mexican Investment Funds Law; 18 of the Mexican Pension Funds Law, and 46 of the Mexican Banking Law.

¹⁴ Only the intermediaries of the securities market are able to develop intermediary activities; otherwise, a criminal sanction will be imposed. Articles 2(XV), 9, 373 and 385 of the SML.

¹⁵ Articles 114, 115, 171 and 350 of the SML.

¹⁶ Articles 171(XIX) and 171(XVII) of the SML.

On the other hand, there are investment advisors which are defined by exclusion. They are neither financial intermediaries of the securities market nor those who are granted taking investment decisions by a proxy to act on another's behalf or provide investment guidance sporadically. It is relevant to notice that under the Mexican Law, investment advice services are not considered as intermediary activities¹⁷; therefore, any person can provide them, regardless of whether they are financial intermediaries¹⁸, investment advisors or non-professional individuals. However, the legal situation of those providers will change if these services become their regular occupation or part of their professional activities, as they will become subject to the SML.

In an opposite way to financial intermediaries, the investment advisors are prohibited from receiving clients' funds or assets to hold or have custody of them¹⁹. This fact is the pivotal point on which lies the Mexican deregulation of investment advisors, as will be shown later. Basically, this deregulation of investment advisors consists in not having any relation with the CNBV²⁰. This means that investment advisors are not authorized, supervised or regulated by the CNBV²¹.

However, this deregulation does not mean that investment advisors market is free of failures and a regulatory intervention is not needed. Actually, the SML imposes some duties and prohibitions on investment advisors²². Almost all of them coincide with those imposed on financial intermediaries when providing investment advice services. Fiduciary duties –diligence and loyalty– are imposed to both providers²³, which are enclosed by some standards of conduct known as *Conduct of Business Obligations*²⁴. These fiduciary duties and standards can be summarized as provisions that aim to ensure that investment advisors act in the client's interest behalf²⁵.

Nevertheless, both providers, financial intermediaries and investment advisors, can be subject to conflicts of interest which might change their incentives to fulfil those fiduciary duties. However, the potential conflicts of interest between both providers could be different whether (i)

¹⁷ Article 225, third paragraph of the SML.

¹⁸ Nevertheless, the financial intermediaries can provide these services as long as they were legally authorized. Articles 115(I.d) and its last paragraph, 116, 171(IX) and 171(X) of the SML; and articles 1 Bis (II.a) and 2 Bis of the Mexican Regulatory Provisions to Brokerage firms.

¹⁹ Article 227(III) of the SML.

²⁰ Before the SML came into force, another legal framework was applicable to investment advisors, in which (i) investment advisor had to notify to the CNBV about the beginning and ending of their activities; (ii) the personnel of investment advisors had to be authorized by the CNBV, and (iii) the CNBV could fine investment advisors for the breach of any of their legal duties, regardless of other legal liabilities. Article 12 Bis of the Old Mexican Securities Market Law.

²¹ Article 225, fourth paragraph of the SML.

²² Articles 226 and 227 of the SML.

²³ The SML indicates that brokerage firms who hold the power to take discretionary decisions –managing discretionary accounts– should do so in a prudent way, according to contracts provisions and the clients' investment profiles, taking care of the investments as own. This specification of the SML does not however means that investment advisors do not have this fiduciary duty due to the fact that Mexican Civil Law –supplementary Law of the SML– impose exactly the same duty to everybody who acts by proxy on another's behalf. Article 200(VIII) of the SML and article 2563 of Mexican Civil Code.

²⁴ Conduct of business obligations can be defined as those principles of conduct which should govern the activities of financial services firms in protecting the interest of their customers (IOSCO's Conduct of Business Principles, p. 36; Bombín, 2008, pp. 221, 226-239).

²⁵ Articles 189, third paragraph, 190, 196, 200, 203, 226, 227 of the SML; 118 and 120 of the Regulatory Provisions to Brokerage Firms.

they hold clients' resources or not, and (ii) they can perform or provide other activities or services. Thus, legal duties to avoid conflicts of interest could also be different.

2.3. Why is the Mexican Case Special?

The deregulation of investment advisor apparently is an asymmetry of international trends. In 2004, the MiDIF included investment advice as a service that requires authorization to be provided professionally²⁶ due to "the increasing dependence of investors on personal recommendations"²⁷. This recognition led to those professional providers of investment advice services to be supervised by a competent authority in the Member State²⁸. Hence, European regulation seems like a policy opposite to the Mexican deregulation of investment advisors, who provide their services without any regulatory requirement or intervention by the CNBV.

On the other hand, IOSCO recognizes investment advisors as being different to market intermediaries. However, the applicable principles to them are also applicable to investment advisors with some variations (IOSCO's Principles, pp. 39-40). IOSCO also requires investment advisors to be under a licensing and supervision regime (IOSCO's Principles, pp. 5, 40), but there is one exception: investment advisors "who neither deal on behalf of clients nor hold client assets nor have custody of client assets nor manage portfolios, but who only offer advisory services without at the same time offering other investment services" through a market intermediary, the license of the latter would be enough to act as an investment advisor in those terms (IOSCO's Principles, pp. 5, 40). This flexibility is different to Mexican investment advisors, who do not need a license or authorization, because IOSCO excludes portfolio management services and sets the condition to be linked to financial intermediaries in order to not require a license.

Therefore, it seems that the Mexican case differs from the international trends, which establish a prior authorization as an entry requirement and a supervision regime to investment advisors. However, they are recognized as a special case and international regulation allows exceptions or modalities among the duties, supervision and liabilities in relation to those applicable to financial intermediaries. For instance, the MiDIF sets out that in the case that investment firms provide only investment advice –without portfolio management²⁹– the Member States can allow the competent authority to delegate administrative, preparatory or ancillary tasks related to the granting of authorization; the review of the conditions for initial authorization, and the regular monitoring of operational requirements to other entities³⁰. Therefore, European legislation also recognizes there can be less government intervention when investment firms provide only investment advice services in strict terms.

On the other hand, IOSCO recognizes that there are different types of investment advisors and their regulation increases as they gain discretionary power over the investor's assets. For instance, if an investment advisor in addition deals on behalf of customers, the capital and other operational controls applicable to financial intermediaries should as well apply to the investment advisor. On the other hand, if the advisor does not deal with client's assets, but is

²⁶ Article 4.1(4), 4.1(9) and numbers (4) and (5) of the Section A, *Investment services and activities*, of the Annex I of the Directive 2004/39/EC.

²⁷ Third whereas of the Directive 2004/39/EC.

²⁸ Articles 5.1 and 17 of the Directive 2004/39/EC.

²⁹ See MiDIF's definition of investment advisor at item 2.1.

³⁰ Articles 5(5), 16(3), 17(2) and 48(2) of the Directive 2004/39/EC.

permitted to have custody of them, regulations should provide for the accurate protection, including segregation and periodic inspections, either by the regulator or an independent third party (IOSCO's Principles, pp. 39-40).

In sum, Mexican investment advisors are not authorized, supervised or sanctioned by a government agency. However, the international trend also considers, though in a different way, investment advice services as a different case from financial intermediaries. Whether the investment advisor holds funds or assets of their clients and exclusively provides personal investment recommendations or not, the MiDIF and IOSCO point out a different regulatory intervention.

3. Fixing Market Failures: The Economic Public Interest Theory of Regulation.

Given the regulatory facts pointed out in the last section and assuming the efficiency of the investment advice services market as a goal, a primary question arises from the deregulation of the Mexican investment advisors: is it economically necessary to regulate investment advice providers? And then, why do the regulatory disparities between the financial intermediaries and investment advisors exist? To address these questions, it is necessary to recall that regulation of investment advisors, whether or not they are financial intermediaries, is based upon a market system.

In a market system, transactions for goods and services are based totally upon what makes economic sense. Assuming rational behaviour, freedom and fairness (Schäfer and Ott, 2004, p. 275), parties to the transaction maximize their utility (Pindyck and Rubinfeld, 2005, pp. 64-66, 75-76). The individual gains, if the transaction does not impose costs to third parties, represents gains on social welfare according to the economic theory (Ogus, 1994, pp. 15-16, 23-25). In this context, the legal system is relevant to enforce the essential agreements of trade through remedies against breach of contracts –forcing specific performance or requiring compensation from those who breached (Ogus, 1994, pp. 2, 16, 23, 25-26; Schäfer and Ott, 2004, pp. 278, 299-301). Otherwise, the efficiency would be lost because somebody would be worse off³¹.

Nevertheless, according to the economic theory, the market system needs to meet some conditions in order to produce its, privately and socially, efficient outcomes: (i) utility-maximizing behaviour, (ii) full information, (iii) absence of externalities and (iv) competition (Ogus, 1994, pp. 23-24). When one or more of these conditions are not present there will be a “market failure”, which sometimes can be corrected by regulation in its broad sense.

The Economic Public Interest Theory of Regulation identifies regulation as a corrective of deficiencies in the operation of the market which would not occur without such intervention (Ogus, 1998.a, p. 75 and 1994, pp. 1-3, 29-46). This intervention attempt “to control, order, or influence” the agents’ conducts (Black, 2002, p. 1). However, regulation in its broad sense does not need a directive character or require a centralized enforcement system by the State, as traditionally it had been considered (See Black, 2002, p. 1; Parker, et al., 2004, p. 1; Ogus, 1994, pp. 3-4, 15, 28). Therefore, the Law can be a kind of regulation (Black, 2004, p. 34), as the SML is in the Mexican case.

³¹ In economic terms, civil liability or compensatory damages follows what is known as Kaldor-Hicks principle, which establishes whether the benefits for those who gain against the welfare of others are enough to potentially compensate fully all the losers and still remain better off, it is still efficient because at least one is better off and no-one worse off (See Ulen, 1998, p. 481; Schäfer and Ott, 2004, p. 326; Ogus, 1994, pp. 24-25).

Furthermore, regulation can come in a wide range of forms, from *Private regulation* or Contract Law provisions³², enforcing by private parties (Ogus, 1994, p. 5; 2006, p. 99), to full government intervention. The latter means regulation in its traditional sense: directive rules pursuing collective goals which are setting of and enforcing by the State –*Command-and-control regulation* (Ogus, 2006, pp. 83-85). Nevertheless, under the Economic Public Interest Theory of Regulation when regulation pursues collective goals is named *Social Regulation* and tends to centre on two types of market failure: asymmetric information and adverse externalities (Ogus, 1994, pp. 3-4, 15, 28).

There are market failures in the investment advice services. However, depending on the kind of provider –financial intermediary or investment advisor– the failures in the market can vary or affect efficiency in different levels. Furthermore, some of these distortions could not need a regulatory intervention but be corrected by the *informal institutions* in the market. Therefore, it will be necessary consider those aspects in order to determine if investment advice services really need a regulatory intervention in its broad sense.

3.1.Negative Externalities: Systemic Risk

Normally, contracting with others will be economically efficient –one or all parties gain and no one loses–. However, market transactions may have spillover effects or externalities which adversely impose costs to individuals who are not involved in the transactions and thus will not satisfy the efficiency test (Ogus, 2006, p. 76; Goodhart, et al., 1998, pp. 5, 8-9, 192).

Misbehaviours or inaccurate diligence of financial intermediaries could affect the stability of financial system as a whole (Philipsen, 2008, p. 96; Goodhart, et al., 1998, p. 5; Finsinger, 1996, p. 243). Thus, systemic issues are central in the regulation of financial intermediaries (Goodhart, et al., 1998, pp. 5, 8-10; Llewellyn, 1986, pp. 10-11, 19), as reduction –not elimination (IOSCO's Principles, p. 5; Goodhart, et al., 1998, pp. 14-15)– of “external costs of chaos and disruption” (Breyer, 1998, p. 72). As long as the investors' resources are at risk, an opportunistic behaviour or negligence on them might lead to the failure of a financial institution. This may cause losses to individual investors, but the contagious effects to other financial institutions can lead to a financial distress (Llewellyn, 1986, p. 12; Dewatripont and Tirole, 1994, pp. 73-74, 85-87). Thus, the social costs can easily exceed the private cost of failing financial intermediaries (Goodhart, et al., 1998, pp. 8, 9, 189; Finsinger, 1996, p. 243).

Systemic risk is therefore the main reason why financial intermediaries' regulation differs from that of investment advisors, who do not hold client's money. Financial intermediaries' regulation is more commanded and its enforcement stronger because of systemic risk. Thus, regulation and supervision costs can be seen as the risk premium against a financial system failure (Goodhart, et al., 1998, p. 9; Breyer, 1998, p. 71).

Mexican investment advisors do not impose a negative externality on the stability of the financial system due to the fact that they do not hold investors' money or assets. Therefore, their deregulation, at first sight, is economically justified.

³² The traditional *Private regulation*, which imposes non-modifiable private obligations and can be enforced only by the individuals for whose benefit they have been created, could be seen as the rules of contracting and enforcing contracts. Furthermore, if regulation in a broad sense does not mean directive rules, *Private regulation* is a regulatory perspective of Contract Law (See Collins, 2004, pp. 13-15; Black, 2004, pp. 41-42; On the opposite, cfr. Ogus, 2006, p. 99; 1994, p. 5).

3.2. Asymmetric Information: Adverse Selection and Moral Hazard Problems

According to the economic theory, allocative efficiency³³ depends critically on two basic assumptions: (i) rational decision-makers have complete and full information on the set of alternatives available and their consequences and (ii) they are able to process that information (Breyer, 1998, p. 72; Ogus, 1994, p. 38). “A significant failure of either assumption may set up a *prima facie* case for regulatory intervention” (Ogus, 1994, p. 38).

Unregulated investment advice services suffer imperfections in both the conditions mentioned above, so it leads to a market failure that could impede the production of efficient outcomes from those services: asymmetric information (Philipsen, 2008, pp. 94-95; Van den Bergh, 2007, pp. 2-3). This market failure is present in investment advice services because (i) they are experience goods or even more credence goods, which results in an adverse selection problem; and (ii) they involve a principal-agent relationship, creating a moral hazard problem.

3.2.1. Adverse Selection: Market for Lemons

There is an asymmetry of information between investment advisors –included financial intermediaries– and investors. Investment advisors have perfect information about the full characteristics of their services before and during the execution of the contract. The situation is different to investors because the quality of the investment advice services cannot be fully assessed (Black, 1997, pp. 141-144; Hackethal and Jansen, 2008, p. 7).

The advisor’s performance might not necessarily be correlated with the profits (Black, 1997, p. 141) –which could not be maximized– or the losses –because all investments represent a risk, even if they have been done according to the investor profile³⁴–. This situation is worse in the case of retail investors because of their lack of expertise in investments (Black, 1997, pp. 143-144).

Nevertheless, professional investors are more able to evaluate the quality of investment advice services. They actually have the expertise to make investment decisions by themselves and assess risks³⁵. Thus, they are able to evaluate the quality of investment advice services, at least, after the results of the first period of the provision of the services and to react. Therefore, investment advice services are “experience goods” –those for which their quality is revealed only after one “purchases the product” (Schäfer and Ott, 2004, pp. 359-360)– to professional investors.

On the other hand, the small or retail investors, whose lack of expertise in investments are translated into the inability to assess or to process information about the quality of investment advice services (Goodhart, et al., 1998, pp. 6-7). Therefore, retail investors trust on their investment advisor (Black, 1997, p. 142) because they cannot evaluate –either before or after purchase– the quality of the services. For this situation, investment advice services can be catalogued as “credence goods” (Schäfer and Ott, 2004, pp. 359-360).

³³ See definition of allocative efficiency in *supra* note 2.

³⁴ Inclusively, when financial advisors continuously provide investment products that increase investors’ wealth, their reputation is enhanced. After acquiring enough market share, those advisors reduce the quality of their services (Ismail, 2008, pp. 2, 11, 23).

³⁵ Annex II, *Professional Clients for the Purpose of This Directive*, of the Directive 2004/39/EC.

Nevertheless, both types of the investors cannot determine the quality of the products before making a purchase. The economy theory points out in these situations, consumers can only discriminate by basing their decision on prices. In consequence, the chosen product might not meet their preferences and then, an adverse selection would arise as a result of the lack of signals relating differences in the quality of similar products. Hence, the providers of higher-quality products will be driven out of the market and there will be general lowering of the standards of quality. Inclusively, there will be a reduction of the size of the market or, in an extreme case, a collapse of the market (Philipsen, 2008, p. 95). This process is known as “market for lemons” (Akerlof, 1970, p. 488). Thus, regulation is recalled to avoid this overall quality deterioration in the markets.

3.2.2. Moral Hazard: The Agency Problem

In economic terms, contracting investment advice services implies the investor (the “principal”) delegating decision-making power over its resources to the investment advisor (the “agent”) (Lindsey, 1999, p. 297; Ogus, 2006, p. 61). After signing the contract, this relationship could generate an agent’s *ex post* opportunistic behaviour (Schäfer and Ott, 2004, p. 277) when there is a discrepancy between the goals of the agent and the interest of the principal or, in other words, a conflict of interest³⁶.

The information available about the provision of the services and usually the expertise of the investment advisor is much greater than those of the investor (Ogus, 1994, pp. 17-18), so the advisor could engage in hidden actions that would not be aligned to the investor’s interest (Schäfer and Ott, 2004, p. 276). Thus, investor does not know whether investment advisor’s actions put them at a disadvantage or whether the decision-making power is well-developed. It would require them to invest significantly high transaction costs (Van den Berghm, 2007, p. 3). Therefore, this disadvantage could generate an investor’s welfare reduction because if investor advisors do not follow their clients’ interests, the quality of their services will not be as they should have been.

In this way, conflicts of interest determine a quality standard of investment advice services and in order to develop the objectives of this study, it will be assumed that the quality of such services is only given in terms of the advisors’ conflicts of interest. Thus, to achieve that investment advice services are provided without conflicts of interest, it is necessary to keep investment advisors aligned with investor’s interest. “Controlling *ex post* opportunism behaviour requires mechanisms that reduce the *opportunism premium*”, the profit from opportunistic behavior (Schäfer and Ott, 2004, pp. 368, 370). Nevertheless, those mechanisms can be set by regulation or by *informal institutions*.

3.2.3. The “Invisible Hand” is Present

Sometimes the market can actually deal with the quality deception problem and regulation may not be necessary. In an unregulated system market, reputation might be a

³⁶ In economic terms, it can be said that investment advisors will act with a conflict of interest because their expected utility from following that own or foreign interest is greater than their expected utility from acting according to the investor’s interest.

mechanism to punish –not legally, but in economic terms– the provider who does not meet consumer expectations after purchase. Thus, reputation can be considered an *informal institution*.

Reputation actually provides additional information about the quality of the investment advice services and the uncertainty faced by the consumer can be eliminated by the principle of induction: “the future is judged on the basis of the frequency of occurrences of particular events in the past” (Schäfer and Ott, 2004, p. 366). This can not only save the cost of searching for quality services and avoid the risk of being disappointed about the quality of products³⁷, but also create a self-reinforcing mechanism which induces the suppliers to keep the quality level of their services³⁸.

If investment advisors reduce the quality of their services, it might be profitable at the beginning until their clients can detect investment advice given under a conflict of interest. Thus, the cheater advisor will run the risk of losing clients in the future, negatively affecting his *goodwill premium*, which means that “branded” suppliers can charge higher prices for exactly the same product available on the market from a competitor, and consumers are willing to pay to avoid the risk of being disappointed (Schäfer and Ott, 2004, pp. 365-367). If there is a sufficient number of individuals at the margin that are able to detect the deception and leave those providers³⁹, investors may have enough power to discipline the low-quality advisors when the *opportunism premium* is overweight. Furthermore, this fact will affect the reputation of the investment advisor, which will mean losing potential clients⁴⁰.

However, it is necessary that consumers must be able to detect the deception⁴¹. In the investment advice market, professional investors might be able to detect a failure in the quality of the services and use the market mechanism to punish low-quality advisors, but retail investors cannot do not so (Van den Bergh, 2007, p. 4; Philipsen, 2008, p. 96). Furthermore, if the professional investors at the margin do not represent an important number of investment advisors’ clientele, the market mechanism is not enough to maintain the quality of the services.

In consequence, the economic analysis of law sets when the market system cannot censure providers of services, liability for opportunistic behaviour makes sense as a second best (Ogus, 1994, pp. 17-18; Schäfer and Ott, 2004, pp. 392, 394), which means a regulatory intervention in its broad meaning (Collins, 2004, pp. 13-15). Considering that all analysed jurisdictions regulated investment advisors, it would be assume that it is the case of investment advice services.

In order to determine the efficiency of the Mexican investment advisors’ regulatory framework to addresses this market failure, the next Section will analysis and compare the Mexican case with the provisions and recommendations set out by the MiDIF and IOSCO to

³⁷ Due to a prior purchase, consumers will infer that this will be the case in the future as well. Reputation is stronger when is supported by a trademark or brand. Reputation and brands provide economic reassurance that the supplier will not disappoint consumers with the quality (Schäfer and Ott, 2004, pp. 365-367; Griffiths, 2008).

³⁸ Reputation as a self-enforcing mechanism means repeated interaction over time that makes the parties cooperate to achieve better outcomes, because any deviation will be punished in the future (Hviid, 2000, pp. 55-56; Schäfer and Ott, 2004, pp. 365-367, 381, 393).

³⁹ This means that consumers can migrate to another provider, which will depend on homogeneity of the goods in a competitive market and the transaction costs to get information about the quality (Schäfer and Ott, 2004, pp. 348, 360-361).

⁴⁰ The incentive to avoid a reputation for having a negative characteristic, such as giving investment advice where there is a conflict of interest, is likely stronger than the incentive to acquire a reputation for having a positive characteristic (Griffiths, 2008).

⁴¹ According to economic theory, reputation will be an effective self-enforcing mechanism between fairly homogeneous groups. This means between professionals in investments (Hviid, 2000, p. 56).

regulate those investment advisors who do not hold investors' money and assets. Thus, there is not a systemic risk to consider, no matter whether they are considered financial intermediaries or not by their respective jurisdictions. Therefore, the next analysis does not include financial intermediaries' regulation.

4. Regulatory Differences Impact Quality: Forms of Social Regulation

The Economic Public Interest Theory of Regulation assumes that any intervention in the market is directly towards gaining and improving in social welfare (Ogus, 2006, p. 71), if the costs of regulation do not outweigh the benefits (Philipsen, 2008, pp. 94-95; Ogus, 1998.a, p. 79). In other words, an efficient regulatory framework allows individuals to maximize their utility and avoid having external costs borne by third parties (Ogus, 1994, pp. 16, 23-25; Schäfer and Ott, 2004, pp. 3, 8-9, 21-23). Under public interest approach, legislators and regulators have the task to design a regulatory framework to pursue collective goals (Ogus, 1994, pp. 3-4, 15; Philipsen, 2008, pp. 94-95). However, this Social Regulation can take different forms and its monitoring and enforcing task can be developed by public or private agents (Ogus, 2006, pp. 78-86).

The SML, the MiDIF and IOSCO principles have established different forms of social regulation to ensure a minimal quality standard of investment advice services, in terms of conflict of interest. These forms can be divided in (i) prior approval regulation, (ii) setting of standards, (iii) enforcing standards, and (iii) monitoring compliance.

4.1. Prior Approval Regulation

According to the theory, information deficits about the quality can be overcome by mandatory entry measures to the market, such as prohibition of engaging in an activity without a license of authorization issued by a government agency or another entity appointed by the law (Ogus, 1998.a, p. 79). If regulation is able to set and enforce quality standards than any uncertainty in the market would disappear and thus the "lemons market" risk (Ogus, 1994, p. 5; Schäfer and Ott, 2004, p. 364).

Licensing –through authorization or registration– or a certification system increases information about professional services by establishing certain standards for entrants, including those to prevent or reduce frauds (Moore, 1984, pp. 267, 269). This sends a signal to consumers regarding the reliability of the average performance of the providers and thereby reduces the uncertainty faced by consumers (Schäfer and Ott, 2004, p. 365).

Although theoretically licensing is different to certification and registration⁴², in practice, financial regulators have imposed a mandatory entry requirement to provide investment advice services, which consists of meeting specific standards for entering into the profession of investment advisors. Mexican investment advisors do not need prior authorization from the CNBV to provide their services, but a certification of individuals' quality is required⁴³; while the MiDIF and IOSCO require an authorization or license, respectively. Regardless of prior approval forms or additional requirements pertaining to investment advisors' skills, there is a common quality standard required by Mexican, European and IOSCO's regulators to provide investment

⁴² See comments of Ogus and Veljanovski to Moore (1984, pp. 273-274).

⁴³ Article 226(VI) of the SML.

advice services which is related with our term of quality: the good reputation of the individual who directly acts with the public investor.

4.1.1. Good Reputation Standard to Ensure Quality

In the Mexican case, those individuals who directly act with the public investor in the provision of investment advice services⁴⁴ must hold a certification issued by a self-regulatory association, proving their good reputation⁴⁵. The MiDIF establishes that investment advisor natural persons or tied agents of financial intermediaries should be of sufficiently good reputation, though the former is under the authorization system as a market intermediary⁴⁶ and the latter, under a registry system⁴⁷. Finally, IOSCO proposes a licensing regime to act as an investment advisor and sets that this license should not be granted to persons who have violated securities or similar financial laws, or criminal statutes during a specified time period preceding their application (IOSCO's Principles, pp. 5, 40). These regulatory facts show that regulators are concerned about the potential moral hazard problem in investment advice services. Therefore, to reduce the risk of *ex-post* opportunistic behaviour and then ensure a minimal standard of quality, regulators make good reputation a mandatory standard for entry.

The requirement of good reputation can be explained in economic terms by two different goals: (i) incapacitation, which is about preventing an individual from engaging in an illegal act that he previously committed⁴⁸, or (ii) deterrence of a first offence, this means that this future incapacitation will be included in the expected sanctions of the wrongdoers before they break the law for the first time⁴⁹. Being a previous offender reveals to the government that an individual is more prone to illegal activities⁵⁰; thus this information is useful and should be taken into account when granting approval to act as an investment advisor, who has an important fiduciary duty to their clientele: the public investor.

4.1.2. Is It Necessary to have a Public Registry of Investment Advisors?

Although Mexican regulation is aligned to the minimum entry standards imposed by international trends to individuals that directly provide investment advice services, an administrative difference remains. Mexican investment advisors, natural or legal persons, do not

⁴⁴ This requirement is also applicable to brokerage firms' personnel who provide investment advices to clients. However, these individuals must be additionally authorized by the CNBV. See articles 193 of the SML; 3 to 5 of the Mexican Regulatory Provisions to Stockbrokers and Representatives of Intermediaries in the Securities Market to Celebrate Transactions with the Public, and 5, 6 to 9 of the Mexican Regulatory Provisions to Self-regulatory Associations recognized by the National Banking and Securities Commission.

⁴⁵ Article 226(VI) of the SML.

⁴⁶ Articles 5(1), 5(4), 9(1) and 9(4) of the Directive 2004/39/EC.

⁴⁷ Articles 23(3), 23(5) and 23(6) of the Directive 2004/39/EC.

⁴⁸ From the economic point of view, the social benefit from incapacitating an individual is the harm he would commit if he were in a position to commit a criminal act (Shavell, 1987, pp. 107, 109; Cooter and Ulen, 2007, p. 535).

⁴⁹ According to the economic *deterrence model* –an increase in expected punishment causes a decrease in crime– it could be socially desirable to punish him more severely –incapacitating him– in order to deter him in the first place (Cooter and Ulen, 2007, pp. 493, 535-536).

⁵⁰ An individual's offense history signals the likelihood of an individual committing more illegal acts in the future (Cooter and Ulen, 2007, p. 536).

need prior official authorization granted by the CNBV and they or their certified personnel must not be registered in any public registry. This situation differed not only to the case of Mexican financial intermediaries⁵¹, but also to European practices and IOSCO principles.

European investment advisors, as financial intermediaries, need a prior authorization and being registered in a public registry administrated by each Member State of the European Union, where it will point out the services that they are authorized to provide⁵². If they are firms, in addition, their tied agents should be registered in another public registry established for this purpose⁵³. The establishment and operation of both registries is costly that, independently of who bear the costs, will result in inefficiency if they are greater than the benefits that these regulatory measures aim to achieve.

Assuming that a certification, as in the Mexican case, and an authorization, without registry, is enough to ensure a minimal standard of quality and send this signal to investors, the extra requirement of registration might seem excessive in the case of investment advisors who do not hold investor's resources and furthermore, do not provide portfolio management as the European case is⁵⁴. This is due to the fact that the marginal benefit of registration for each individual may be less than the marginal social cost of establishment, maintenance and operation of these two public registries, because the previous authorization granted is enough to identify investment advisors who fulfil the minimal standards of quality.

Nevertheless, the European case has an additional variable to consider establishing a public registry of financial intermediaries that includes investment advisors. The creation of a single financial market in the European Union⁵⁵ might imply that uncertainty of investment advisors' quality increases when the borders are opened. The search costs to verify the quality of investment advisors are high and therefore the existence of a solely public registry by country can reduce these costs among the participants of the European securities market.

On the other hand, IOSCO recommends that licensed providers should be in a date list of authorized investment advisors (IOSCO's Principles, pp. 5, 40). However, according to IOSCO, investment advisors can hold or have in custody clients' assets (IOSCO's Principles, pp. 39-40). Therefore, the benefits of that list might be worthwhile to investors because the risk of *ex post* opportunistic behaviour is higher than in the Mexican case, so they might need an extra requirement of certainty about the quality standard of investment advisors.

Taking into account the three cases above, it can be concluded that a prior license, authorization or certification is enough to ensure a minimal quality of investment advisor when they do not hold investors assets. This prior approval is sufficient to send a signal to the public investor about the quality of the services and thus avoid the adverse selection problem. However, in a securities market where the search costs are high, as the European single market is, a public registry is necessary to reduce those costs.

⁵¹ Articles 193 of the SML, and 3 to 5 of the Regulatory Provisions to Stockbrokers and Representatives of Intermediaries in the Securities Market to Celebrate Transactions with the Public.

⁵² Articles 5(1) and 5(2) of the Directive 2004/39/EC.

⁵³ Articles 23(1), 23(3) and 23(5) of the Directive 2004/39/EC.

⁵⁴ See discussion *supra* pp. 232, 234. It does not mean that a legal or natural person cannot be authorized to provide both investment advice in strict terms and portfolio management services. However, the regulatory measures differ in that case. Articles 5(1), 6, and numbers (4) and (5) of the Section A, *Investment services and activities*, of the Annex I of the Directive 2004/39/EC.

⁵⁵ Second whereas of the Directive 2004/39/EC, and Bombín (2008, pp. 219-221).

4.2. Setting of Standards

If it is assumed that the adverse selection problem caused by the deficit of quality information is solved with the prior approval regulation, the agency problem remains. It was also shown that the market mechanisms might not be enough to maintain the quality of investment advice services, making the introduction of liabilities necessary.

However, a liability implies a previous breached duty. The investment advice services contract cannot totally constrain the risk of *ex post* opportunistic behaviour, though the client might be a professional investor. Due to the fact that there is a practical inability to identify all potential conflicts of interest that the investment advisor can face after signing the contract and to plan specific arrangements for each possible situation (Williamson, 1979, pp. 237-238; Goldberg, 1976, pp. 427-428). Thus, the protection of investors' interests is incomplete and might costly (Ogus, 2006, p. 61). Furthermore, the best investments to an investor are varied according to the conditions in the market, innovations on financial products or other circumstances; thus, the good performance of the investment advisor and potential investor's benefits could be affected by a restricted terms contract (Hviid, 2000, pp. 50, 52-53, 58). For this flexibility requirement, investment advice contracts can be catalogued as what is known relational or administrated contracts (Williamson, 1979, pp. 237-238; Goldberg, 1976, pp. 427-428).

Therefore, a regulatory intervention, which sets and enforces a conduct standard, might be needed to reduce *ex post* opportunism behaviour in order to ensure the quality of investment advice services. In economic terms, a contract is valid because it increases the utility of both the parties; otherwise, "intervening in the contract is legitimate" (Schäfer and Ott, 2004, pp. 296-297).

4.2.1. The Common Standard

In order to reduce the agency cost, regulation could impose fiduciary duties, which involve duties of care and loyalty (Ogus, 2006, p. 61). This means those duties are legally enforceable rules and instructions about behaviour during the life of the contract (Collins, 2004). These regulatory provisions fill the gap of the incompleteness of investment advice services contracts⁵⁶. In economic terms, these fiduciary duties reflect what would have been voluntarily agreed in a detailed contract, if the investor had been fully informed about all the future circumstances (Polinsky, 1989, p. 27; Ogus, 1994, pp. 17-18). In other words, this intervention does not violate the principle of freedom of contract, assuming the fiduciary duties will be worthy to both parties and therefore, the contract will be efficient (Schäfer and Ott, 2004, pp. 296-299).

All the analysed jurisdictions impose a fiduciary obligation on the investment advisors, requiring them to act in the best interest of the investor and other standards of conduct to avoid conflicts of interest⁵⁷. Thus, these regulatory duties induce the reduction of *ex post* opportunistic behaviour and in consequence, better standards of quality of investment advice services.

⁵⁶ Regulation can be seen as an implicit contract. Thus, in addition to written contracts, regulatory provisions establish rights and obligations to the parties as a part of the contract (Goldberg, 1976, pp. 427, 429; Collins, 2004), pp. 13-15, 23-28).

⁵⁷ See Schäfer and Ott (2004, p. 5); article 19 and 18 of the Directive 2004/39/EC; articles 21, 22, 23, 27-39 of the Directive 2006/73/EC; IOSCO's Principles, pp. 36-38 and IOSCO's Conduct of Business Principles, Principles, Part IV.

4.2.2. Differentiating Standards

Regardless the general fiduciary duty, the analysed regulators have been recognized the difference expertise among the investors. In consequence, they have set out segregate duties or liability exceptions to investment advisors, according to each kind of investors who can be their clients. This makes completely economic sense because (i) the information asymmetries between professional and retail investors are inversely proportional to investment expertise (Schäfer and Ott, 2004, pp. 9-10), and (ii) the attitude towards risk might have the same relation to that expertise, depending on that fact the individual willingness to pay *insurance premium* against the risk of deception of quality (Schäfer and Ott, 2004, pp. 338-339).

The economic theory point out that under conditions of uncertainty about the quality of products, consumer's behaviour will be different depending on their attitude towards the risk of disappointment of quality. Investors can differ in their willingness to bear that risk, so they can be: (i) risk adverse, willing to pay for an insurance premium to avoid taking a risk, even when the insurance premium would be greater than the expected risk, because the faced risk creates disutility to them; (ii) risk neutral, indifferent between certain and uncertain events with the same expected utility, and (iii) risk loving, gamblers who prefer a risky income to a certain income that generates the same expected utility⁵⁸.

Although among investors, professional or retail, all kind of attitudes toward risk exist. This study assumes that risk aversion will decrease as long as investment expertise increases. Thus, professional investors will be considered risk neutral due to the fact that they can detect a deception in the quality of the services and react in consequence. Being risk neutral, they are not willing to pay *insurance premium* because the expected utility at the moment of purchase of the service is the same that they can obtain through compensation in the case of deception. In the opposite way, because of their lack of expertise to assess the quality of the investment advice services, retail advisors will be assumed as risk adverse because the risk of disappointed causes disutility to them. Hence, they will be willing to pay an *insurance premium* to avoid the loss associated with the quality deception.

Under the above assumption and regulation as insurance against deception, a "full protection" regulation to professional investors would be inefficient. *Ceteris paribus*, the costs of following regulatory standards will be incorporated in the production costs of investment advisors and investors will pay them in the price for services at the end (Llewellyn, 1986, p. 47). Assuming a competitive market, in which investment advisors are price taking, the prices of services will be higher than they would have been to professional investors, or other risk neutral or risk loving investors.

Inclusively, professional investor would subsidize the price to retail investors (Craswell, 1998, pp. 7-8; Chandler, 1999, pp. 841-842). Due to the cost of regulation are in a common pool, a common price is shared to both kinds of investors. Hence, it is larger to professional investors, who are not willing to pay the *insurance premium*, but lower to retail investors because the "excess profits" earned from professional investors cover part of the cost of regulation that only retail investors should have covered.

⁵⁸ For a wide explanation see Pindyck and Rubinfeld (2005, pp. 159-161) and Schäfer and Ott (2004, pp. 285-286).

For the reasons above, the regulatory differentiation to professional and retail investors as clients of investment advisors is economically justified because this segregation avoid the inefficiencies of pricing higher professional investors and the cross-subsidization price.

4.3. Enforcing Quality

After setting of the standards of conduct, a regulatory system need established the process for monitoring compliance with and mechanisms for enforcing them. In economic terms, individuals do not follow a rule because of a moral or ethical value, but because of their self-interested calculation lead them to do so (Kornhauser, 1989, p. 44). Therefore, in order to achieve that regulatory quality standards were followed, regulation should invert the incentives of defect the quality of investment advice services.

The economic analysis of law supports when the consequences for breaching a duty makes an individual fully internalize the costs that his acts impose over others, they are enough to deter an undesired behaviours (Cooter and Ulen, 2007, pp. 491-494). Assuming that investment advisors are fully informed and rational, they will avoid conflicts of interest if the expected sanction is overweight their *opportunism premium* (Schäfer and Ott, 2004, p. 370). The expected sanctions are given by the magnitude of possible sanctions and the probability of the application of those sanctions (Shavell, 1993, pp. 261-262, 266). Thus, to ensure the quality of investment advice services, an efficient regulation should determine the type and magnitude of sanction, as well as the mechanism of enforcement –monitoring and punishment– in optimal terms (Shavell, 1993, pp. 261-270).

4.3.1. Professional Investors embed in “Private Regulation”

Due to the fact that investment advisors are not subject to the CNBV supervision, the detection of breaching and the enforcement of regulatory duties depend on investors. Therefore, the investment advice services are embedded in a *Private regulation*, imposing non-modifiable private obligations⁵⁹ and other defaults rules⁶⁰, which can be enforced only by the individuals for whose benefit they have been created. However, investors must be able to detect the deception to request compensation; otherwise, the low probability of detection would not deter investment advisor (Shavell, 1993, p. 275).

Professional investors are the natural customer of Mexican investment advisors because they are able to evaluate the quality of the investment advice services. Therefore, the provisions of the SML and the clauses of the contract that they negotiate are enough to ensure the quality of those services or, otherwise, to request compensatory damages.

Actually, Mexican investment advisors are only subject to civil liability⁶¹. In economic terms, this means they bear the risk of investments made under conflict of interest (Polinsky,

⁵⁹ There are legal prohibitions which will lead to a strict civil liability if they are breached. Article 227 of the SML.

⁶⁰ The legal rules of contracts can be mandatory or supplementary (immutable or default rules). The default rules can be adjusted to parties' preferences prior agreement, but the immutable rules cannot change by contractual agreement. Hence, regulation takes a directive character. Nevertheless, these mandatory rules are justified by the economic point of view: “a contract that is not *ex ante* Pareto-superior should be corrected by the law” (Schäfer and Ott, 2004, p. 297). See also Ayres and Gertner (1989, p. 87); Schäfer and Ott (2004, pp. 296-299); Ogus (1994, pp. 29-30); Collins (2004, pp. 13, 17, 24-25, 27-30, 32).

⁶¹ Article 227 of the SML.

1989, pp. 59, 65). Assuming that both professional investor and investment advisor are risk neutral, under the economic theory this allocation of risk is efficient because the latter is the cheapest cost avoider (Schäfer and Ott, 2004, p. 283). Investment advisor is fully informed about the causes of conflicts of interest, information that would be highly costly to professional investor obtain it. Furthermore, professional investor is indifferent to breach if he is fully compensated. Therefore, civil liability is an efficient remedy in this situation, even though it does not deter breaching⁶², because a Kaldor-Hicks criterion is met⁶³.

Inclusively, professional investors have the power to increase the expected sanction of investment advisors through the market mechanism. Reputation plays a significant role to investment advisor –at least until now– because they have financial intermediaries as competitors, who are usually linked with powerful brands such as City Group, HSBC, BBVA, among others. Thus, losing reputation, as a part of expected sanction (Shavell, 1993, pp. 278-279; Kornhauser, 1989, pp. 43-44), could be an enough deterrence mechanism to investment advisors, who need to gain good reputé in the eyes of investors.

In sum, Mexican investment advisors' regulatory framework is implicitly designed to provide another option of suppliers to professional investors who are not willing to pay the *insurance premium* that supervision of financial intermediaries involves. Potential compensatory damages, plus the risk of losing reputation, might be enough to induce the good performance for investment advisors or, in case of breach, to ensure that compensation will return professional investors to the position that he would have been in if the contractual obligations had been fulfilled.

Nevertheless, the deregulation of Mexican investment advisors grants another kind of provider, so competition increases in the investment advice market and “competition plays a major role in generating economic welfare” (Ogus, 2006, p. 76). However, the deregulation of Mexican investment advisors might produce efficient outcomes in the market, but to be conclusive, it is necessary determine if this deregulation do not affect retail investor protection.

4.3.2. Retail Investors protected by “Command-and-Control regulation”

Assuming that retailer investors are risk adverse, they will not contract to Mexican investment advisors due to their natural uncertainty about the quality of those services. They will prefer to obtain investment advice from financial intermediaries because they are regulated, supervised and sanctioned by the CNBV. In other words, the fiduciary duties and standards of conduct in the provision of investment advice services, as the other financial intermediaries' activities, are enforced by a *Command-and-Control regulation*. This sort of regulation does not aim to compensate the affected investors⁶⁴, but to prevent those acts that are harmful to them (Ogus, 1994, p. 5; Shavell, 1993, pp. 257-258).

Investors perceive *Command-and-Control regulation* as *insurance*, even though it does not aim to nor remove all risk from investors (Goodhart, et al., 1998, pp. 14-15, 62, 192). Thus,

⁶² The compensatory character of civil liability cannot be used to penalize for defecting, because it leaves the risk neutral wrongdoer in the same position than before breaching or even more, with a gain –if the opportunism premium is greater than compensatory damages (Alessi and Staaf, 1989, p. 189).

⁶³ See *supra* note 31.

⁶⁴ However, financial intermediaries are responsible for civil damages; regardless other administrative or criminal sanctions were imposed (Article 198 of the SML).

being supervised plays a role of signalling or “branding”. Hence, retail investors, who are willing to pay the costs of supervision included in the price of the services (Goodhart, et al., 1998, pp. 14, 63, 190) as a guarantee⁶⁵, would choose financial intermediaries as their investment advisors. Therefore, if we assume that *Command-and-Control regulation* is effective in their task of monitoring and enforcing conduct standards and its outcomes are socially efficient, the preference of retailer investors to financial intermediaries means that the deregulation of Mexican investment advisors does not mean less protection.

The MiDIF’s provisions and IOSCO’s recommendations leave that each country determines the conducts to be sanction and the sort of sanctions that could be imposed to investment advisors, regardless they were responsible for civil damages to their clients⁶⁶. Those punishments could be administrative fines or criminal sanctions⁶⁷. Furthermore, the financial authorities are able to revoke their authorization or license; to remove individuals of their positions, to suspend their activities or to impose a permanent inability to participate in the financial system⁶⁸.

However, this might be economically justified because extra sanctions would begin to be important as long as: (i) retail investors contract with investment advisors, because the likelihood of detection and imposition of civil liability is low (Shavell, 1993, p. 275); (ii) the investment advisors have discretionary power over investors’ welfare or hold investors’ money or assets, due to the benefits that individuals can obtain for *ex post* opportunistic behaviour are large, which makes them difficult to deter (Shavell, 1993, p. 277), and (iii) holding investors’ resources also involves systemic risk, thus the expected harm to society is substantial (Shavell, 1993, pp. 277, 279-280).

4.4. Monitoring Compliance: Costs, Economies of Scale and Signalling Devices

Being an implicit part of the relational contract, regulation needs set a system for monitoring compliance with the established standards of conduct. Otherwise, detecting quality deception or the breach of regulatory provisions would be highly difficult, not achieving the desired efficient outcomes (Goodhart, et al., 1998, pp. 9-10). However, monitoring implies costs and therefore, efficiency is recalled again in order to reduce those costs until the point at which benefits are maximized (Ogus, 1998.a, p. 79).

4.4.1. Saving Agency Costs by Economies of Scale

In the case of investment advice services, a centralized monitoring agent has advantages over a decentralized system. Potentially substantial economies of scale can be secured through, not only common regulatory provisions (Goldberg, 1998, p. 428; Trebilcock and Dewees, 1981, p. 96), but also supervision of investment advisors. A centralized monitoring system saves two sets

⁶⁵ Perhaps, to avoid misunderstood among investors, the SML impose to investment advisors the duty to disclose to their clients that they are not subject of the CNBV’s supervision. Article 226(VII) of the SML.

⁶⁶ Articles 23(1) and 23(2) of the Directive 2004/39/EC, and IOSCO’s Principles, 2009, p. 15.

⁶⁷ Articles 51(1), 54 of the Directive 2004/39/EC; IOSCO’s Conduct of Business Principles, Part I, point 20, and IOSCO’s Principles, pp. 15, 37, 39.

⁶⁸ Articles 50, 51(1) of the Directive 2004/39/EC, and IOSCO’s Principles, pp. 15, 39, 40.

of costs: (i) the substantial duplication of monitoring, as if all investors monitor individually the same processes social costs would be excessive; (ii) the loss of the economies of scale that are derived through a specialist supervisor's acquiring expertise and establishing effective monitoring systems (Llewellyn, 1986, p. 20; Goodhart, et al., 1998, pp. 9-10).

Furthermore, a centralized system represents more advantages to retail investors due to their inability to evaluate the quality of investment advice services. The time, effort and resources that they would have to spend to be able to monitor investment advisors on an individual basis would be inordinately large (Goodhart, et al., 1998, p. 10). Professional advisors will contract supervised investment advisors if the costs of supervision are less than the costs of monitoring by themselves (Williamson, 1979, pp. 245-248). Thus, with a specialist monitoring agency, investors delegate to the supervisor some monitoring responsibilities, obtaining the benefits of the economies of scale and hence, reducing the total social costs of monitoring (Goodhart, et al., 1998, pp. 10, 164-165).

4.4.2. Self-regulation as a "Brand"

Since Mexican investment advisors are not subject to the CNBV's supervision, a private monitoring system remains to enforce the duties that the SML impose over them (Collins, 2004, pp. 23-25, 27). However, investment advisors regulatory and enforcement systems can be different if they belong to a self-regulatory body. The SML establishes they can be voluntarily affiliated to a self-regulatory association of investment advisors recognized by the CNBV⁶⁹. In this case, they also have the legal duty of following the self-regulatory norms that such association enacts⁷⁰. Essentially, these self-regulatory associations have the goal of implementing conduct and operation standards among their members⁷¹ and to do so they can enact and enforce several self-regulatory norms which rule among their members⁷².

Although entry to a self-regulatory association is a contingent fact, there are enough incentives to investment advisors affiliated to a self-regulatory body: signalling or *branding* their services (Black, 1997, pp. 80, 133). In that way, investment advisors could increase the demand for their services, being self-regulation as reassurance of quality (Emons, 1989, pp. 46-47; Alessi and Staaf, 1989, pp. 190-191). Retailer investors are willing to pay the cost of supervision as an *insurance premium*, to avoid the risk of deception (Goodhart, et al., 1998, p. 62). Therefore, being part of a self-regulatory association, investment advisors identify themselves as providers of services with better standard of quality and avoid the adverse selection among retail investors or other risk adverse investors.

In addition, the retail investors' market is mostly covered by financial intermediaries, who are often linked with powerful brands such as City Group, HSBC, BBVA, among others⁷³. In order to be able to compete in this market, investment advisors need to gain positive reputation

⁶⁹ Article 225, second paragraph of the SML.

⁷⁰ Article 226(V) of the SML.

⁷¹ Article 228 of the SML.

⁷² Even though, the CNBV can veto the self-regulatory norms. Articles 226(V), 229, 231(I) and 350 of the SML.

⁷³ Investors may choose leading brands because they are familiar with them and already available information. Brands act as an "availability heuristic", which simplifies their decision-making. Investors can also be "anchored" to their initial choice of investment advisors, no matter how good the service is on an absolute basis (Griffits, 2008; Mitchell and Utkus, 2004, pp. 17-18).

in the eyes of investors. Hence, there is another incentive for investment advisors to affiliate to a self-regulatory association and meanwhile, to maintain the quality of their services.

4.5. Imposed Self-regulation versus Voluntary Self-regulation

In contrast with the Mexican case, according to the European legislation and IOSCO principles, investment advisors have to be supervised; however, they recognize that this task does not require the intervention of an authority. The MiDIF sets out that in the case that investment firms provide only investment advice in strict terms, the Member States can allow the competent authority to delegate administrative, preparatory or ancillary tasks related to the regular monitoring of operational requirements to other entities⁷⁴. As well, IOSCO consider self-regulatory organizations as a complement to state regulation and allow for them to exercise some direct oversight responsibility (IOSCO's Principles, pp. 12-13, 15, 39-40).

Apparently, this delegation is closer to the Mexican approach of self-regulatory body's supervision, but the main difference is that being a member of a Mexican self-regulatory body is voluntary, whilst the supervision on European and IOSCO's investment advisors is mandatory. This fact brings some consequences that may be inefficient.

4.6. Imposing Taxes and Cross-subsidization

Mandatory supervision –by the government or self-regulatory body– might not be efficient in case that investment advisors who do not hold investor's resources because it imposes the costs of supervision. Therefore, the prices of services will be higher than they would have been to professional investors, or other risk neutral or risk loving investors. In other words, the costs of this imposition have the effects of a tax (Llewellyn, 1986, p. 28), the burden carried only by the consumer, and results in a deadweight loss⁷⁵. Another problem that a mandatory supervision generates is a cross-subsidization of retail investors by professional investors (Llewellyn, 1986, p. 48) to cover the *insurance premium* against defect of investment advice services.

In sum, the Mexican investment advisors' legal framework does not cause those social welfare losses, leaving those providers voluntarily affiliated to a self-regulatory body. This fact might only occur when the investment advisors want to increase their services demand among the retail investors. Meanwhile, for these investors, regulation, supervision and sanction of self-regulatory association can serve the same purpose as government intervention: an insurance of a minimal standard in the quality of these professional services (Schäfer and Ott, 2004, p. 363-365; Ogus, 1994, p. 56).

4.6.1. Information Advantages of Self-regulation

There is a wide debate about the advantages and disadvantages of self-regulation for professional services in both economic and legal terms (Van den Bergh, 2007, pp. 7-8; Ogus,

⁷⁴ Portfolio management is not included in the investment advice services defined by the MiDIF. Thus, in contrast to the Mexican case, European authorities cannot delegate supervision tasks over portfolio management activities. Articles 5(5), 16(3), 17(2) and 48(2) of the Directive 2004/39/EC.

⁷⁵ For details see Pindyck and Rubinfeld, 2005, pp. 326-328.

1998.b; Black, 1997, pp. 55-80). However, the disadvantages might be more associated with when self-regulation is imposed than when it is voluntary.

Self-regulation has been perceived “to provide flexible regulation, expertly designed and sensitively enforced” (Black, 1997, p. 80). In economic terms, this could be translated as an instrument to correct a market failure at fewer costs than conventional public regulation (Ogus, 1998.b, p. 374). Some arguments in favour of self-regulation are: (i) it has significant information advantages about the quality standards of professional services (Ogus, 1998.b, p. 374; Van den Bergh, 2007, p. 7) because members of an industry have greater degree of expertise and technical knowledge to guarantee high standards of conduct (Black, 1997, p. 56; Ogus, 1998.b, p. 374); (ii) thus, they are better able to monitor compliance with and enforce the regulatory standards (Van den Bergh, 2007, pp. 7; Black, 1997, pp. 148-155) without impede innovation in the financial services (Black, 1997, p. 56); (iii) the costs of formulation and interpretation of quality standards, including the intensity and flexibility to adapt them to the current circumstances (Black, 1997, pp. 56, 112), as well as the cost of monitoring and enforcement might be lower to a professional self-regulatory body than to the government (Philipsen, 2008, pp. 101-102; Black, 1997, p. 80; Van den Bergh, 2007, pp. 7-8), and (iv) members of the industry might feel more committed to rules protecting the high standards of the profession enacted by themselves than to statutory regulations on quality (Van den Bergh, 2007, p. 7; Ogus, 1998.b, p. 379).

Apparently, these advantages are recognized by the European legislation and IOSCO and thus, authorization process and some or all regulation or monitoring tasks on investment advisors might be delegated to a self-regulatory body. However, the mandatory nature of this supervision could bring the disadvantages of self-regulation.

4.6.2. Potential Dangers of Mandatory Self-regulation: Rent Seeking and Regulatory Capture

Independently that it could be claimed a lack of democratic legitimacy (Van den Bergh, 2007, p. 8; Ogus, 1998.b, p. 376), if the investment advisors are obliged to pass through the authorization and to be under the supervision of a self-regulatory body, as European and IOSCO’s jurisdictions might delegate; self-regulatory bodies may divert them away from public interest goals to private interest claims (Ogus, 1998.b, p. 374). In this situation, self-regulatory bodies may abuse their power to act as a cartel or to restrict competition (Ogus, 1998.b, pp. 374-375; Black, 1997, p. 80), being worse when that body is a monopoly (Ogus, 1998.b, p. 379-380, 382). Hence, the advantages of self-regulation will not materialize under this scenario.

Being mandatory to be authorized and to fulfil the regulation enacted by a self-regulatory body in order to act as an investment advisor, the members of this organization have incentives for a potential rent-seeking behaviour (Van den Bergh, 2007, p. 7). This means that the self-regulatory body could increase the costs (i.e. fees, unnecessary certifications) of new participants as an entry barrier to the market (Black, 1997, pp. 78-79). Therefore, restrictions on entry decrease the supply of professional services below the social optimum, increasing the prices to consumers and the income of the current professionals in the market (Van den Bergh, 2007, pp. 6-8; Philipsen, 2008, p. 101). For its opponents, self-regulation, in the financial sector, “provide a fertile ground for fraud and provide inadequate protection for investors” (Black, 1997, p. 80).

On the other hand, the authorities who delegated powers to a self-regulatory body might not prevent this abuse due to the information disadvantage of the profession. Government

authorities must rely on the information provided by the industry to enact regulation and might not identify when these regulations, in all of their forms (entry requirements, standards of conducts, sanctions applied), are necessary or are disproportionately, affecting the competition in the market. Therefore, “self-regulation has been described as the ultimate form of regulatory capture” (Van den Bergh, 2007, p. 6)⁷⁶.

In sum, this mandatory self-regulation makes the industry acquire the control of regulation, which might be designed and operated entirely for the benefit of the insiders in the market (Black, 1997, pp. 60-61), generating cartelization effects (Van den Bergh, 2007, pp. 6, 25). Thus, if the government authorities are not able to detect and control the possible abuses (Ogus, 1998.b, p. 375), the task of regulation to correct market failures might not be achieved efficiently and another problem in the market can arise.

4.6.3. Voluntary Self-regulation: Ensuring the Goals

Voluntary self-regulation, as in the Mexican case, does not present the disadvantages described above due to the fact that potential members can choose to keep themselves unregulated. Also, the current members can react against an abused regulatory policy, leaving the self-regulatory body and, if they represent a significant number, affecting the reputation of that association. They can also form another self-regulatory body with better policies. Under a competitive scenario, the risk of lost reputation can prevent potential abuses within self-regulatory bodies and the advantages of self-regulation to ensure the quality of the services will be present (Black, 1997, p. 72). Therefore, prestigious professional self-regulatory bodies will induce providers of services to affiliate them, “*branding*” their services to alter consumers’ perceptions about their quality.

In conclusion, the voluntary self-regulation scheme that the SML points out brings better outcomes in the market for investment advisors than the mandatory authorization and supervision that the European legislation and IOSCO principles suggest. The main reasons are: (i) the costs of supervision are not obligatory, which otherwise are included in the price paid by investors, including the professional investors who, in principle, are not willing to pay for it; (ii) the risks of self-regulatory bodies’ abuse are less because potential competition and risk of loss of reputation exists, and (iii) prestigious and fair self-regulatory bodies bring investment advisors to affiliate to them as a signal to consumers of the quality of their services and, hence, the quality of the services in the market would increase.

5. The Law as a Market Signal: The New Face of Regulation

The SML plays with the incentives that *informal institutions* provide to induce of investment advisors increase the quality of their services voluntarily. The voluntary character of affiliating to a self-regulatory association shows that regulation plays a guidance role (Black, 1997, pp. 124-125). This means that setting of non-enforceable standards of conduct, individuals obey them, believing on reasonable grounds that they are acting in conformity to the Law (Black, 1997, pp. 124-125). Furthermore, the SML also can alter investors’ perceptions about the quality

⁷⁶ The *Capture Theory* is part of the Private Interest Theories of Regulation and appoints that groups of interest are continually influencing political decision, but afterwards, the regulatory outcomes are not open to change. Philipsen (2008, pp. 97-98, 101); Ogus (1998.a, p. 78, 80, 82, 84, 86) and (1994, pp. 57, 58, 69-71, 73, 75).

of investment advice services, with neither command-control nor guidance rules, but sending market signals.

Considering the Mexican context, the legal reasons why the SML sets out a series of provisions to investment advisors is not clear when it was deregulating. In legal terms, the common legislation –Civil or Contract Law– would have been an enough regulatory regime to produce the same legal outcomes. To do so, the SML only needed to point out that (i) investment advice services are not considering intermediary activities, which are exclusive to financial intermediaries and (ii) holding a certification issued by a self-regulatory association is a requirement to provide this services in a professional way.

Regardless the two aspects above, the Mexican common legislation establishes a legal framework to contracts of the same nature than investment advice services in which the latter would have been embedded, imposing the same legal consequences and the private enforcement that the SML establishes: (i) the explicit and implicit fiduciary duties and compensatory damages for breaching are in the common legislation⁷⁷; (ii) the prohibition of receiving money or resources from their clients⁷⁸ and their duty to disclose that they are not subject to the CNBV's supervision⁷⁹ –which means not operating as or pretending to be a financial intermediary in front of the public investor– are enclosed by the general prohibitions of the SML, covering by administrative and criminal sanctions⁸⁰; (iii) the rest of the legal duties do not have explicit sanction⁸¹, and (iv) the affiliation to a self-regulatory association is voluntarily. Hence, if there is not a legal reason to incorporate all these provisions in the text of the SML, another one must be behind.

5.1. Pointing out where looking for Quality

A first explanation of the phenomena explained above is that the SML is avoiding an adverse selection problem, which makes totally economic sense in a dynamic and static way. Considering the regulatory events, investment advisors were legally recognized in 2001 through a specific regulatory framework⁸² which was valid until the deregulation in 2006. Therefore, investment advisors' disappearance of the text of the Law could have confused investors about if they have the same rights than before or, inclusively, about the legal existence of investment advisors. Thus, this lack of signalling might have caused an adverse selection problem against investment advisors.

Furthermore, the text of the SML in itself is a signal about the quality of investment advisors and the level of protection against the risk of deception. The market signals that the

⁷⁷ Articles 2563 and 2565 of Mexican Civil Code.

⁷⁸ Article 227(III) of the SML.

⁷⁹ Article 225(VII) of the SML.

⁸⁰ Articles 373 and 385, 392(III.b) of the SML.

⁸¹ Only breaching the prohibitions of the article 227 and contract provisions lead to request civil damages. The rest of the duties do not have any explicit remedy for breaching.

⁸² The Old Securities Market Law was amended in 2001. Before that amendment, investment advice services were an exclusive activity to financial intermediaries. Thus, in 2001, investment advisors were recognized as an exception to provide this services, being a condition to fulfill the duties established by that statute. Article 12 Bis of the Old Securities Market Law.

SML sends are: (i) the brand of “investment advisors”⁸³, (ii) investment advisors are professionals⁸⁴, (iii) they guarantee a minimal standard of quality (certification)⁸⁵, (iv) some of them do not offer insurance against the risk of deception (no supervision)⁸⁶ and (v) others do so and their level of quality might be better (self-regulatory body affiliation)⁸⁷. All of these signals can be an important reduction of the search cost of investors. Moreover, the SML helps to investors to evaluate quality, at least, at the moment of purchase. All those duties that apparently do not have legal sanction not only have a guidance character to investment advisor, but also enlighten investors which are the minimal standards of quality at the moment of contract investment advice services⁸⁸.

Therefore, the legal provisions of the SML send signals to investors that reduce their uncertainty about the quality of the investment advice services and also the adverse selection problem considerably. Moreover, these quality signals not only make investment advisors maintain the quality of their services, but also increase it. As in a sequential game⁸⁹, the investment advisors know that investors can discriminate between those providers that are not affiliate to a self-regulatory association. In order to compete in the market, the investment advisors have incentives to affiliate to those sorts of associations and thus, to meet and to maintain the quality of their services. Therefore, the services in all the market will increase.

5.2. The Softest Version of the Private Interest Theory of Regulation.

A second explanation could be given by the Private Interest Theory of Regulation, which appoints the roles of the groups of interest in the formation of regulation. These groups are continually influencing political decision in order to seek rents for themselves, which is often unproductive from a social welfare point of view (Philipsen, 2008, pp. 97-98, 101; Van den Bergh, 2007, pp. 6-7; Ogus, 1998.a, pp. 78, 80, 82, 84, 86 and 1994, pp. 57, 58, 69-71, 73, 75).

Even though the Mexican Independent Investment Advisors Association (AMAI) –the only self-regulatory of investment advisors body recognized by the CNBV at the moment– was invited to discuss the draft of the SML by the financial authorities regard their deregulation⁹⁰, it is unlikely that investment advisors exercise any bargain power over the authorities. Investment advisors are the main competitors of financial intermediaries in the investment advice market and there is a wide difference of market share between them⁹¹. Thus, inferring that financial

⁸³ The Old SML only allowed “other persons” to supply some of the intermediary activities provided by financial intermediaries, but it was not a proper recognition of “investment advisors” as a legal figure. Article 12 Bis of the Old SML.

⁸⁴ Article 225 of the SML.

⁸⁵ Article 226(VI) of the SML.

⁸⁶ Article 225, fourth paragraph of the SML.

⁸⁷ Article 225, second paragraph of the SML.

⁸⁸ Article 226 of the SML.

⁸⁹ A sequential game is part of the economic theory of games or Game Theory that analysis how agents make strategic decisions taking into account other’s actions and responses. In sequential games players move in turn, responding to each other’s actions and reactions (Pindyck and Rubinfeld, 2005, pp. 473-474, 489).

⁹⁰ AMAI web site.

⁹¹ At the end of December 2011, brokerage firms had 199,694 investments accounts and the value of the clients’ assets managed by them reached \$6,023,375.9 million of Mexican pesos (US\$468,668.6 million approximately), whilst those managed by the investment advisors affiliated to AMAI through 3,272 contracts celebrated with their EALR, V. 3, n° 2, p. 228-259, Jul-Dez, 2012

intermediaries hold stronger bargain power, supported by their market share and brand power, they would not have allowed investment advisors to promote rules with adverse effects to the market.

However, investment advisors needed to protect their presence in the market in order to avoid an adverse selection problem against them and also to compete with the financial intermediaries. Therefore, if the current regulatory framework of Mexican investment advisors was influenced by the AMAII, it could be seen as the result of the softest version of the Private Interest Theory of Regulation. Even though a group of interest influence in the formation of regulation, the outcome was productive from a social welfare point of view, as this study showed.

Even though, this “signalling regulation” could be useful as in the Mexican case, which promotes competition, efficiency and investor protection, it warrants attention in its potential dangers. This kind of regulation could also work in an opposite way, at the point in which the Private Interest Theories of Regulation are stronger. Unfortunately, that analysis escapes from the scope of this study.

6. Results and Conclusions.

The case of the deregulation of investment advisors in Mexico proves that a regulatory legal framework free of government intervention does not reduce investor protection if it provides (i) the sufficient incentives to ensure a minimal quality standards in the services that investors receive and (ii) the signals that reduce their uncertainty about the quality of those services and other characteristics, such as *insurance* against the risk of deception.

The above is supported by the economic analysis of the law models, which was showed through this study. Even though the deregulation of Mexican investment advisors seems to split away international regulatory trends, releasing investment advisors of any government directive intervention, it is totally justified in economic terms. Moreover, the reason why investment advisors’ regulation differs from financial intermediaries’ regulatory treatment lies in the same economic justification.

Financial intermediaries are authorized, regulated and supervised by the authorities in order to control systemic risk in the financial sector, being this a compelling reason why that stronger regulatory intervention exists. Mexican investment advisors do not hold investors’ funds or assets, so they do not represent a systemic risk problem. This justifies their deregulation in economic terms, which does not mean that they are released of a regulatory regime, in the broad sense of regulation. A market failure remains to correct.

The nature of investment advice services leads to asymmetric information problem between investment advisors and their clients. Investors are not able to determine the quality of the investment advice services before signing the contract and afterwards, a principal-agent relationship co-exists in these services. This information asymmetry increases in the case of retail investors, who are not able to assess the quality of investment advice services after contracting neither.

Professional investors can detect a quality deception and, assuming competition, leave the low-quality investment advisor, which is only given in terms of conflicts of interest in this study. Thus, reputation, as an *informal institution*, plays a central role to keep the quality of the services

clients picked up \$79,387 million of Mexican pesos (US\$6,176.9 million approximately). AMAII Introduction and Brokerage Firms, Statistics Report 2011, CNBV.

in the market. Apparently, it has been assumed that market mechanisms are not enough and a regulatory intervention is necessary to avoid conflicts of interest in the provision of investment advice services.

Regardless the detailed differences among the analysed jurisdictions, if we assume that the regulatory duties of investment advisors –who do not hold clients’ funds or assets– achieve the same outcomes if they are fulfilled; Mexican regulatory framework has the following advantages:

1. It ensures the common international quality standard of entry.
2. It does not impose the costs of regulation and supervision to risk neutral or risk loving investors and, thus, gives them another option for providers. This also avoids the cross-subsidization price from these investors to risk adverse investors.
3. It recognizes market signals are enough to protect retail investors, who will prefer regulated investment advisors –by financial authorities or by self-regulatory association–, even though they will have to bear an increase on prices because of the *insurance premium*.
4. Only those investment advisors who aim to target retail investors or “branding” their services will be affiliated to a self-regulatory body. Thus, they will fulfil higher standards of quality or control of conflicts of interest. These standards might provide the protection that retail investors need due to their inability to assess the quality of the services.

In addition, Mexican regulatory framework leads self-regulation to produce its advantages. The voluntary character of affiliating to a self-regulatory association allows investment advisors to react against adverse self-regulation. Thus, anti-competitive practices and regulatory capture could be avoided.

The advantages in the investment advice services and self-regulatory markets that the SML achieves are proof that regulation, in its “guidance role” –setting of non-enforceable standards of conduct–, can provide sufficient incentives to promote investor protection. The SML induces the provision of investment advice services with better standards of quality, considering the enforced mechanisms that provide *informal institutions* (reputation and branding).

The text of the SML also shows that regulation can also play a “signalling role”. Only two of the SML’s provisions would have been necessary to produce the same legal outcomes than the current regulatory framework of investment advisors. Most of the duties and liabilities set out by this statute were covered by the Mexican common legislation and the rest do not have explicit sanctions for breaching or it is voluntarily to follow them.

However, those written provisions send market signals to investors that identify investment advisors as other competitors in the market of investment advice services, and provide information about the quality among them and their *insurance* against deception. Therefore, adverse selection against investment advisors is reduced and investors can choose, among them, those providers that meet better their preferences and needs. Thus, retail investors, assumed as risk adverse, can identify and choose investment advisors that offer the *insurance* of supervision. In short, the SML, playing its signalling role, promotes investor protection.

In sum, the deregulation of investment advice services in Mexico, supported by the economic analysis of the law models, proved that a regulatory framework can influence the actors’ behaviour –producers or consumers– only with *setting of standards* as guidance rules and, what is more, as “market signals”. The rest of the requirements of regulation –*process for monitoring*

compliance with and mechanism for enforcing— are not necessary for achieving efficient outcomes in the market, promoting competition and providing consumer protection at the same time.

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