Next Generation

Daniel Favoretto

# Conflict of interests in high-tech investment advisory

Nr. 4

EIZ Publishing

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# Next Generation

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# Conflict of interests in high-tech investment advisory

Daniel Favoretto

## About the Authors

### Book's author – Daniel Favoretto

Competition lawyer, Consultant under the United Nations Development Programme (UNDP) and Non-Governmental Advisor (NGA) at the International Competition Network (ICN). Former peer-reviewer for the Brazilian Competition Authority (CADE). In the legal practice, he has worked in leading law firms in Brussels (Belgium) and São Paulo (Brazil). Guest member of Harvard's 2023 GenAI Working Group (D3 Institute). He holds the legal title of *meester* from the Dutch Ministry of Education (DUO), a master's degree (*cum laude*) in Law & Development and a bachelor's degree in Law from FGV Law School (*Fundação Getúlio Vargas*), where he worked as assistant lecturer and researcher. Author of academic works published in Europe and Latin America. Throughout his studies, Daniel has been awarded scholarships for distinguished academic performance.

### Guest author (foreword) – Nuno Cunha Rodrigues

Associate Professor of the University of Lisbon School of Law (FDUL) and holder of a Jean Monnet Chair from the European Commission (2018). President of the Portuguese Competition Authority (AdC) and Bureau member of the OECD Competition Committee. Doctor (PhD) in Legal and Economic Sciences, Master in Legal and Business Sciences, and Bachelor in Law from the FDUL. Vice-President of the European Institute of the FDUL. Prior to being President of the AdC, Nuno was a lawyer and arbitrator. Author of books and papers on Competition Law, European Union Law, Public Procurement, Economic Law, Public Finance and Tax Law.

The perspectives presented in this book are solely the author's and do not necessarily reflect the views of any individual or institution that interacted with the author during the production of this book or the research that preceded it. In addition, the author remarks that, during his professional activities, he has never advised, acted on behalf of or provided services to any investment advisor or brokerage firm, such as those mentioned in this book.

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Finally, I remark and appreciate the support given by ANBIMA, through the XVI *Anbima Prize for Scholars*, and *Fundação Getúlio Vargas*, through the scholarship *Bolsa Mario Henrique Simonsen de Ensino e Pesquisa*, for my research during the master's programme, in which this book is partially based.

## Executive Summary

This book is an adaptation of the author's master's thesis, which was approved by an interinstitutional board of four professors in 2022 and awarded the national recognition of the *Anbima Prize for Scholars* by the Brazilian Financial and Securities Markets Association.

This book investigates what drives biased investment advisory and how to legally address it in the context of digital investment platforms and genAI products. The hypothesis of conflict of interests in advisory services results from the fact that, in the securities market, investment advisors offer their services to both brokerage firms and investors, thus, serving two "kings" whose interests may diverge. Based on the guiding concept of individual suitability and on the method of case study of Brazil, where investment advisory grew unprecedentedly and a major regulatory reform took place in 2023, this book provides an answer to the following research questions: what are the potential sources of conflict of interests in investment advisory services and how should the law design legal tools of retail investor protection?

Based on empirical research of unprecedented sources, chapters II and III of this book conclude that conflict of interests is a multifactorial risk that arises from (i) compensation conditions according to which the advisor's fee is higher based on specific investment products and/or on the client's account turnover, (ii) use of attractive goal-oriented standards to shape the advisor's incentives, (iii) poor transparency of the advisor's compensation conditions toward the investor, (iv) to a limited extent, burdening fixed costs, and (v) lack of financial education by investors in general, weakening monitoring conditions and favouring adverse selection.

Although the risk of conflict of interests is not *per se* illegal and does not mean that advisors effectively engage in biased conduct, it raises investors' costs of surveillance and chances of harm, reason why the law provides various legal tools of investor protection, in the competition law, regulatory, and private law frameworks. Chapter IV of this book concludes that these legal tools lack a preventive approach and suffer from gaps that limit their deterrent and compensatory purposes.

Chapter V of this book proposes some improvements to the design of the legal tools of investor protection, consisting of a combination of strategies with different levels of intervention and, to prevent overenforcement, a primary focus on investor empowerment for alignment of interests and prevention of biased advisory. However, chapter VI demonstrates that generative artificial

intelligence is transforming conflict of interests into a not exclusively human risk, meaning that the design of legal tools has to also consider how machines "think" and influence investor behaviour.

## Foreword

In 2015, I went to São Paulo, Brazil, to lecture at *Fundação Getúlio Vargas* a short-term course to which I was invited. At that opportunity, I had the pleasure to teach to a wide variety of international students, among whom was Daniel Favoretto, who quickly stood out among his peers due to his intelligence, brightness, and ability of critical analysis.

Since then, I have been accompanying his brilliant academic and professional path, which includes the publishing of relevant academic papers that, along with his significant professional experience, make Daniel a promising jurist at an international level.

In 2022, Daniel concluded his master's in law thesis with distinction, under the title "*Serving two kings in the securities market: conflict of interests and investor protection in the Brazilian law of investment advisors*" (Portuguese version only).

The thesis led to this book, after Daniel's translation and adaptation, as well as updates regarding the investment advisory's fast-paced developments. Given the recognition the thesis received in Brazil, manifested by the Anbima Prize awarded to Daniel's research project, this book is an opportunity for international audiences to get in contact with Daniel's work.

The book shows that investors have legal protection tools against the possibility of biased advisory in Brazil, but these tools suffer from gaps that limit their effectiveness against advisor's conflict of interests and create blind spots of investor vulnerability.

In this context, conflict of interests is not an unprecedented issue. It has been long studied in the business law literature as it is underscored in this book. Nevertheless, the recent wave of digital investment platforms widen access to advisory services and, by that, their potential impact to investors. Daniel Favoretto approaches this framework as a multisided market where the advisor serves two kings (the investor and the broker). For this reason, these professionals can serve either as key support to investors or as instruments to occasionally misuse the securities market.

The book adopts regulatory and private law perspectives along with competition law insights – note, for example, the parts dedicated to analysing market structure and investment platform dominance –, focused mainly on Brazilian law.

However, the book interests any international reader who looks for a relevant analysis and critical perspective used for investor protection – here, it is worth to read chapters II, III and IV –, due to its universal dimension. Despite focusing on Brazilian law, this book provides pertinent comparisons with European law and, most importantly, serves as an interesting case study under a comparative perspective, as well as providing relevant insights to foreign investors in Brazil.

At the end, the book presents some recommendations of legal improvement for better investor protection – chapter V –, which can serve as lessons for other jurisdictions worldwide, along with important and fresh reflexions on generative artificial intelligence – chapter VI.

It will certainly be of interest to any practitioner who works in the securities market and readers interested in the novelties of digital investment platforms and genAI tools.

This is, once more, an excellent academic work of this young scholar who already holds solid recognition, worth being read carefully and, due to its great quality, legitimately raises our expectations for Daniel Favoretto's future works.

Lisbon, 24 April 2023

*Nuno Cunha Rodrigues*

*Associate Professor at Law,*
*Faculty of the University of Lisbon*
*Jean Monnet Chair*

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# I. Introduction

You worked hard for years throughout your life and, after saving some of your income, you decide to invest, while thinking on your future retirement, next generations and even becoming close to what you once thought yourself as being rich. You realized that earning a living is not as simple as you thought it was when you were at school, so why not try to make at least a small portion of your current money replicate itself in favour of your dreams, your loved ones,

and the causes you find worth fighting for in the long term? Regardless of the motive that leads one to make an investment, an investor is an everyday person, hardly the *cliché* tycoon who seats in an office at the top of Wall Street.

However, you do not have enough expertise to explore investment products without feeling at least a bit uneasy about putting some of your hardworking savings to market risk. Therefore, you decide to hire the services of an investment advisor. How costly would it be to later discover that your advisor has incentives occasionally conflicting to yours? What mechanisms and legal remedies do you have to prevent conflict and protect yourself from those incentives?

Attending to various interests, some occasionally conflicting between themselves, is a natural challenge of anyone living in society. Thus, it is reasonable to assert that conflict of interests is a natural human phenomenon. However, on the other hand, impartiality is an intrinsic requirement to the rule of law, which demands unbiased positions from institutions and agents alike in certain situations. The securities market is no different, since it is governed by the law to protect investors from, among other risks, the conflict of interests of market players, which can promote an exploitative effect and induce the market into a crony environment. In other words, conflict of interests is both a human phenomenon and a legal issue.

This book investigates this phenomenon in investment advisory services. As further detailed, many jurisdictions have in their securities market at least one figure that fulfils the role of investment advisory; for example, in the European Union ("EU"), investment advisory can be performed by the so-called tied agents, while, in Switzerland, client advisors are the equivalent party, as regulated by the Swiss Financial Services Act of 2018 and, in Brazil, investment advisors were traditionally known as "autonomous investment agents" until the recent enactment of Law nº 14.317/2022 by Congress and Regulation nº 178 of February 2023, issued by the Brazilian Securities Commission (*Comissão de Valores Mobiliários* or "CVM", for its Portuguese acronym).

These service providers do more than simply provide specialised advice to investors, whereas their role includes prospecting clients to investment firms (*i.e.*, brokers) and transmitting clients' orders to the securities market. Investment advisory can, therefore, be understood as a broad concept that encompasses different forms of assistance to investors, although the provision of specialised advice, in the sense of guiding investors in their decisions, is the main focus of this book.

Conflict of interests in corporations or in financial services has been widely debated, especially in the United States and in European jurisdictions. Despite decades of academic and corporate debate over it, three recent elements brought new shades to this subject, particularly for investment advisory services, namely, globalisation, digitalisation, and generative artificial intelligence ("genAI").

Regarding the first element, as economies became growingly interlinked, options of foreign investments grew, as well as cross-border operation of investment advisors. This bigger complexity of the securities market brought new challenges to enforcement agencies in charge of supervising it, given that potential conflict of interests became simply harder to trace. An example is a recent supervisory briefing report issued by the European Securities and Markets Authority – ESMA (2022) ("ESMA report"), where the European agency mentioned that investment firms should avoid and assess whether the tied agents who they appoint have close links with non-EU entities that could "exercise inappropriate influence over the way in which the tied agent carries out the activities on behalf of the firm".

The second element – digitalisation – also played a key role in shaping conflict of interests in investment advisory services. Due to the use of digital platforms operated by investment brokers, investing became easier and less costly, allowing a wider reach of investment services, including advisory ones. This implicates an equally wider reach of the conflict-of-interest problem, in case of biased advisory services. Furthermore, clients (*i.e.*, investors) have easier access to information through digital tools, meaning they could be more equipped to identify a conflict of interests.

Finally, regarding genAI, this type of product became a global trend in the last year or so, and, though not unprecedented, its use to provide services in many market sectors has become a tendency, including advisory services (Finra, 2020). Though still under debate, the fact that genAI produces content equivalent to human creations brings a new question: how can genAI impact the risk of conflict of interests in investment advisory services?

One can argue that, by replacing humans in at least part of the supply chain of advisory services, genAI can reduce the risk of conflict of interests, which, as mentioned above, is a human phenomenon. On the other hand, one can also argue that the client's lack of deep expertise about the inputs and algorithm functioning of genAI products may actually make biased advice harder to identify, along with the fact that genAI can replicate biased inputs quicker and in wider scale than humans. Thus, the overall expected effect of genAI is ambiguous.

In summary, conflict of interests has recently entered a new moment. Whether this is a new era or a new phase of a known era is a theoretical question that this books sets aside. Pragmatically, law enforcers and policy designers need to understand the peculiarities of this moment and continuously verify if the current legal tools of investor protection are sufficient. Hence, this book proposes a case study about investor protection against biased investment advisory based on Brazil, where the investment advisory market experienced an unprecedented growth in the recent years and a major regulatory reform about investment advisors took place in 2023.

This subject has also been under close attention in the EU. Historically, tied agents were regulated under a 2004 directive (Directive 2004/39/EC), currently known as the "Markets in Financial Instruments Directive I" or "MiFID I", where the EU granted Member States the option to implement tied agent regimes and allow investment firms to operate with tied agents in their respective jurisdictions[1]. In 2014, MiFID I was revoked by MiFID II (Directive 2014/65/EU), which, differently from the previous legal framework, requires Member States to accept operation of tied agents in their securities markets and, thus, implement a tied agent regulatory regime[2]. Moreover, the ESMA report in 2022 also indicates that tuning the right regulatory approach towards tied agents across the EU is a present European concern.

Regarding conflict of interests specifically, there is significant awareness on the topic at the EU level. While MiFID II regulates the matter by imposing obligations over the investment firm that uses tied agents to provide its services, the ESMA report sets its supervisory expectations toward Member States about, among other topics, the way firms should assess and address potential conflict of interests when appointing and operating with tied agents in the European common market.

However, one notes from the ESMA report and the MiFID II that, in the EU level, conflict of interests in investment advisory services is commonly attributed to the investment firm's or the tied agent's capital ownership structure or to "other legal or economic relationships (...) so close as to pose a risk of impairing the independent basis of the advice provided"[3]. A third-party entity other than the tied agent, therefore, is considered as the main source of risk

1 Directive 2004/39/EC, Article 23(1): "Member States *may* decide to allow an investment firm to appoint tied agents for the purposes of (...)" (author's remark).

2 Directive 2014/65/EU, Article 29(1): "Member States *shall* allow an investment firm to appoint tied agents for the purposes of (...)" (author's remark).

3 Directive 2014/65/EU, Article 24(4)(a)(ii).

of a biased investment advisory service[4]. However, as the case study of Brazil demonstrates, such perspective may be insufficient to provide reasonable investor protection in the EU.

Given the above, this work provides a case study of investment advisors in the Brazilian securities market[5], particularly on how Brazilian law designs investor protection against conflict of interests in investment advisory services and the gaps that exist in this legal framework. As further discussed, the investment advisor is an intermediary services provider in the securities and financial markets, who performs the role of agent of an investment firm (broker) in distributing investment products to clients[6]. While advisors can perform a relevant role of disseminating financial education to investors in general and enabling safer investments in complex operations, the possibility of conflict of interests can harm the securities market's stability and welfare.

The choice to study the legal challenges surrounding this market player from a Brazilian perspective should not be read out of context. Conflict of interests in investment advisory has been a trending topic in Brazil over the last years and served as one of the stepstones for a regulatory reform conducted by the Brazilian Securities Commission in 2023, not long after Brazilian investors said they have been "abandoned" by the regulator in the pursuit of damages for defective intermediary services in the securities market (Racy, 2022).

Significant debate has taken place in the country about investment advisors, such as the Brazilian Securities Commission's public hearings to reform the regulatory framework concerning investment advisors[7], the many mergers

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4 ESMA (2022, p. 10): "Adequate mechanisms for the identification of conflicts of interest. The firm should give particular attention to the conflicts of interest which may arise from the relationship between the appointed tied agent and other entities or third-country entities with which the tied agent has close links (e.g., stemming from ownership structure or commercial agreements)."

5 Along this book, investment advisors will be occasionally referred to as, simply, "advisors".

6 Investment advisors operate both on the primary market – *i.e.*, intermediation between investors, who save money to apply in third-party economic activity, and entrepreneurs, who seek third parties' funds to perform their own entrepreneurship – and on the secondary market – *i.e.*, intermediation between investors who trade securities between themselves.

7 Public hearing SDM nº 03/2019, with the stablished objective of "modernizing the rule that governs investment advisory and enhancing the activity of investment product distribution", and the public hearing SDM nº 05/2021, that sought "emending the rules applicable to investment advisors and the disclosure of remuneration of intermediation services for transactions involving securities".

and acquisitions involving investment advisory firms[8], and the repercussion of critics made by Brazil's largest private bank toward these service providers[9]. Competition has been intense between digital investment platforms in a race to hire certain investment advisory firms, suggesting that these agents play a key role in a successful business model of investment product distribution[10].

In addition, the massive rise on the number of investment advisors operating in the Brazilian market, over the last years, serves as another element to suggest the relevance of this topic in that jurisdiction. According to information available in the database of Brazil's investment advisory's official licensing entity[11], the number of certified advisors increased from 4.935 in June 2016 to 22.037 in December 2022 – in other words, the number of investment advisors in Brazil basically quadruplicated in a little over five years.

Among the legal issues concerning Brazilian investment advisors[12], this work focuses on this agent's risk of conflict of interests. Some argue that the fact that the advisor attends investors and, concurrently, is remunerated by brokerage firms can generate conflict of interests, potentially harming its duty to integrity, good faith, and professional ethics, as provisioned in article 23 of Reg. 178[13].

For the purposes of this study, as further detailed in chapter III, conflict of interests is a situation in which an agent has incentives that diverge, either partially or completely, with the interests of the person he or she represents or

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[8] To name a few of these transactions, one of Brazil's major investment advisory firms, *Monte Bravo*, acquired various competitors over the last years, including *Ella's*, *Bolso Forte* and MN *Investimentos*.

[9] Specifically, these critics were made in 2020 through the publicity pieces of *Itaú Personnalité*, as broadcasted on 01 July, 08 July, and 09 July, available in <https://www.youtube.com/watch?v=xRZqRQ1ma30> <https://www.youtube.com/watch?v=bR9DC5-0VoE> <https://www.youtube.com/watch?v=CpNOB2Vf0nw> <https://www.youtube.com/watch?v=ZyU4aRPGZKw>

[10] Regarding the competition over investment advisory firms, see Ragazzi (2021).

[11] Database of *Ancord*, a Brazilian association of brokerage firms. Database available in <https://credenciamento.ancord.org.br/index.html#> Access in: 22/05/2021, 02/01/2022, and 13/11/2022. Also, Ancord's annual report (2023, p. 23).

[12] Though not under the scope of this book, it is worth noting that another controversial aspect of investment advisors in Brazil is their exclusivity conditions with brokerage firms. Some raise competition concerns from these exclusivity deals, since, depending on the equivalent share of the exclusive firms to investment product distribution, these exclusivity conditions can configure barriers to entry, diminishing entrants' and smaller players' capacity to distribute investment products.

[13] Equivalent to article 15 of Regulation CVM nº 16/2021, which was the rule applicable to investment advisors in Brazil until the 2023 regulatory reform.

advises – *i.e.*, to whom the agent should subordinate its interests –, deviating the fiduciary relation between both parties[14]. A widely known example of conflict of interests is one that may exist between corporate managers and shareholders: is the manager operating in the best interest of the company and the shareholders that (s)he represents?

Therefore, when conflict of interests is evoked in this book, it is not being said that advisors necessarily seek to harm their clients, only that they have incentives (embraced or not) to attend to their own interests or to those of third parties in detriment of the investor. This is a key remark, since studying conflict of interests can sometimes lead to the wrong assumption that the agent under study is necessarily ill-intentioned.

In the case of investment advisors, various situations can configure conflict of interests, including managing the client's investment account, operating without licensing, manipulating stock prices, among other conducts prohibited by EU law and Brazil's regulation as well. However, this book focuses on a softer form of conflict of interests, specifically, one in which the dully licensed advisor recommends investment strategies (either buying or selling) that are incompatible with the client's risk profile (thus, without direct interference into the client's actions, such as an illegal account management). It is the influence over the investor that counts for this book.

To identify whether such influence over the investor was undue, this book uses the concept of investor suitability, *i.e.*, the advisor's duty to recommend an investment product that mostly fits the client's investment profile. Suitability is something commonly present in legal frameworks of securities regulation, such as the MiFID II in the EU and Directive CVM nº 30/2021 in Brazil[15]. The basic idea is that, given the client's lack of extensive expertise in investment products, the firm assisting the client must work towards providing the products that are compatible with the client's profile and interests. To use a simple

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14 To clarify the costs incurred by investors from conflict of interests, this book uses two known theories from the economic literature, as later detailed in chapter III, namely, the agency theory and the theory of transaction costs.

15 According to article 3 of Directive CVM nº 30/2021, in order to avoid excessive risk exposure, a suitability assessment must take into consideration, on one hand, aspects of the investment product – *e.g.*, related risks, warranty requirements, and grace period – and, on the other hand, aspects of the client's own profile – *e.g.*, financial condition, investment goals, and investment expertise. Similarly, in the EU, article 25 of the MiFID II requires investment firms to obtain relevant information about clients to assure suitable investment advice, such as the client's "knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation including his ability to bear losses, and his investment objectives including his risk tolerance".

daily example: if a person asks for a simple low-cost vehicle to a car dealer, suitability would be violated if the car dealer recommends the acquisition of a brand-new cutting-edge sports car. However, the securities market is not as simple as that.

In practice, many brokerage firms in Brazil use three categories of risk profiling (conservative, moderate and bold) to define their clients' suitability[16]. Naturally, classifying millions of investors and investment products in only three categories tends to be an excessive simplification of the market, failing to promote an assertive suitability between the investment product and each investor's individual risk profile. Thus, the conflict of interests that matters to this book is the one that deviates the investor's *individual suitability* – *i.e.*, a tailored suitability approach between each product and the client's individual profile –, which may occur even if the general suitability concepts commonly used by brokerage firms are attended.

Going back to the car dealer example, an individually suitable product would be one that considers not only whether the car is a simple low-cost vehicle, but also, *e.g.*, the client's experience in driving automatic or manual transmission vehicles, the level of safety features or car crash risk the client accepts to bear, the client's interest in environmentally sustainable cars, among other possible characteristics.

Although the concept of individual suitability that guides this study does not correspond to the technical concept of suitability currently in force in Brazil, it serves as a reasonably objective criterion to identify investor interests and those that may be conflicting with it. When an investor seeks advisory services, he or she legitimately expects to have a tailored service according to his/her individual characteristics. This does not mean that there is one investment product for each investor in the market and that investment advisory is a game of finding the single correct product. However, it does mean that current suitability standards are overly broad for adequate investor protection.

In summary, based on the guiding concept of individual suitability and on the method of case study of Brazil, this book seeks to provide an answer to the two following questions: what are the potential sources of conflict of interests in

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16 *Portal do Investidor*, 30/08/2021: "The goal is to analyse and classify the investor according to pre-determined risk profile categories, which are commonly set as conservative, moderate and bold, although some institutions use additional categories" (author's translation; originally in Portuguese: "*O objetivo é avaliar e classificar o investidor em categorias de perfil de risco pré-determinadas, em que as mais comuns são conservador, moderado ou arrojado, embora algumas instituições utilizem categorias adicionais.*") Available in: <https://www.investidor.gov.br/menu/Menu_Investidor/funcionamento_mercado/Suitability.html>

investment advisory services and how should the law design legal tools of retail investor protection? Some brief clarifications are worth making about the concepts present in these conducting research questions.

Firstly, the questions are delimited to the retail segment of the securities market because retail investors tend to be more information-deficient than professional or institutional investors[17] and, thus, are presumably more vulnerable to harm from intermediary service providers, including conflicts of interests in advisory services. Secondly, the "design" of legal tools encompasses not only legislative lawmaking, but, also, policymaking and law enforcement, given that these latter activities also shape tools of investor protection.

The question of how tools should be designed seeks minimizing "gaps" of investor protection, *i.e.*, situations in which the application of the law is ineffective or insufficient to allow investors to (i) plainly inform him/herself, (ii) promote an alignment of interests with the advisor, and (iii) be repaired from damage occasionally suffered due to conflict of interests. Thus, for the purposes of this study, conflict of interests is not considered adequately addressed by the law if the investor is plainly informed of the risk of conflict of interests in its advisory services, but lacks effective tools to obtain damages and promote alignment of interests.

To provide an answer to these conducting questions, the research for this book was based on the methods of academic literature review, review of corporate documents, interview of market players and regulators, mapping of State norms, and administrative and judicial case-law research[18].

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[17] Although the amount invested by a retail investor may vary, the fact that, in Brazilian law, the amount is not superior to BRL 1 million allows to assume, in theory, lower expertise about the securities market (depending on a regulatory amendment under discussion, this amount would decrease to BRL 627 thousand, lowering the threshold to qualify an investor as institutional). The Brazilian Securities Commission also associates the category of retail investors to small and low-expertise investors. In this sense, CVM (2021a, p. 7): "(...) retail investor, in other words, the small investor who possesses limited expertise and application ranges. (...) This protection is more demanded for retail investors, who usually do not have a profound awareness of the financial sector or the whole variables that may affect its investments" (author's translation; originally in Portuguese: "(...) *investidor de varejo, ou seja, no pequeno investidor que possui mais limitações de aplicações e conhecimento sobre valores mobiliários.* (...) *Essa proteção é de maior necessidade para o investidor de varejo, que muitas vezes não possui um profundo conhecimento do mercado financeiro e da totalidade de variáveis que o afeta.*").

[18] Literature review was used primarily to form a legal concept of conflict of interests in investment advisory services, due to the lack of explicit statutory definition in Brazilian law. The studied references include Brazilian, European and American academic works in the fields of economics and law, along with press articles and contributions to the Brazilian

To layout the research findings, this book is structured in the following chapters. **Chapter II** presents the practical challenges faced by the author in gathering information about the Brazilian market, while describing the methodology behind this study, and describes the structure and functioning of the investment product supply chain and the investment advisory market, revealing the challenges of regulating it. A work's methodology reveals a lot about the path taken along the research and the criteria used to analyse the object of study. Therefore, far beyond a mere technical description, chapter II reveals the challenges to investigate the Brazilian investment advisory market and how open it is for outsiders.

**Chapter III** presents whether the usual hiring conditions of investment advisors in Brazil have the potential to generate conflict of interests. This chapter was divided in three sections.

The first section details the role of investment advisors and their duties to other market participants, explaining their position of "serving two kings" and using the perspectives of agency costs and transactions costs. Afterwards, through an empirical study of primary sources, such as corporate documents, the second section details the compensation conditions of investment advisors commonly adopted in Brazil.

The third section forms a legal concept of conflict of interests based on Brazilian law and on academic literature of investment advisory. Such legal concept serves to qualify the market practices described in the previous sections, asserting whether a potential conflict of interests exists in Brazilian investment advisory. As it will be noted later in this book, the way through which the market currently operates provides a, at least, potential conflict of interests, due to a multiset of elements that demand an interdisciplinary legal response.

**Chapter IV** maps the legal tools of investor protection provided by competition law, regulatory and private law frameworks in Brazil and their gaps. To provide interdisciplinary and practical contributions to a multidisciplinary problem, this chapter was also divided in sections, each corresponding to the

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Securities Commission's public hearings. The mapping of Statal norms, such as laws and administrative regulations, was conducted in the regulating agencies' digital databases. It revealed how investment advisors have been subject to numerous changes in regulatory requirements over the years and allowed for a detailed description of investor protection tools. The administrative and judicial case-law research was used to evaluate how those legal tools are applied in cases of conflict of interests by the Brazilian Securities Commission and Brazilian courts, which hold jurisdiction to rule cases of regulatory infringements by investment advisors and private law disputes, respectively. The use of interviews and document review will be detailed in chapter II.

legal framework under review, encompassing, namely, antitrust enforcement, contract law, liability law, the Brazilian Securities Commission's regulation, and market-regulated remedies.

These sections include both a description of the applicable legal tools and an analysis of their limits or deficiencies in providing effective investor protection against an advisor's conflict of interests. As later noted in this book, the research revealed gaps in Brazil's legal tools of investor protection, mainly due to the lack of mechanisms to prevent conflict of interests, as well as to the limits of scope and practical use of mechanisms to deter this infringement and repair harmed investors.

**Chapter V** presents some suggestions of improvement of the legal tools analyzed in the previous chapter, for better prevention and suppression of conflict of interests in advisory services in Brazil. **Chapter VI** is dedicated to present whether genAI is a game-changer in investment advisory services and the legal challenges of addressing conflict of interests in this high-tech scenario. To conclude, **chapter VII** sets the concluding remarks, with a summary of potential lessons from the Brazilian experience as this book's takeaways and a research agenda for future works.

As the order of these chapters indicate, this book has been divided in four steps: (i) *identifying the problem* (*i.e.*, whether there is potential conflict of interests in investment advisors' role), (ii) *analysing how the law addresses this problem* (*i.e.*, whether the legal framework provides sufficient tools to protect investors from such conflict of interests), (iii) *proposing improvements for the law to better address this problem* (*i.e.*, possible enforcement and normative improvements in the analysed legal frameworks), and (iv) *defining how genAI affects this problem* (*i.e.*, potential implications of genAI to conflict of interests in investor protection).

## II. Researching Brazil's investment advisory market: Navigating on turbulent and unmapped water

This research found two aspects of the Brazilian investment advisory market that could potentially pave the way for biased advisory and investor harm, namely, poor transparency in market practices and growing risk appetite in

investor adhesion to digital investment platforms[19]. These two aspects, when put together, tend to serve as conditions for overly optimistic investment advice, reduction of investors' awareness about the costs to which they incur, and mitigation of individual suitability standards.

To use a simple analogy, it is similar to safety requirements of touristic attractions in summer vacation: if, on one hand, there is little transparency about the safety conditions of attractions and, on the other hand, tourists are less worried about safety issues because they want to enjoy their sunny summer vacation, the chances of undesired outcomes is greater. If one adds the context of fast-paced market transformation, which challenges attempts of regulation, the awareness of individual suitability tends to become less prominent.

These two aspects – poor transparency in market practices and growing risk appetite in investor adhesion to digital investment platforms – were found in this research as part of the author's challenges to access relevant information and findings about the investment advisory market's ongoing transformations. These two aspects made researching this market an endeavour equivalent to navigating on turbulent and unmapped waters, as detailed below.

## 1. Difficulty in accessing information about the advisory market

The development of the securities market has been a longstanding pursuit over the last decades in Brazil, where private banks and State funds traditionally perform a central role in promoting economic activity (Mattos Filho, 2015), which is a typical trait of developing countries under developmental States. A landmark in this pursuit was the creation of the CVM as the Brazilian Securities Commission, in 1976.

The Brazilian agency has, therefore, close to half a century of existence and recent years have shown a persistent resilience and growth of the Brazilian securities market, as later detailed in this chapter. In other words, the securities market is, by far, not a new topic in Brazil, although it is not traditionally as trending in the academia as in the United States and other jurisdictions.

[19] The term "risk appetite" is used in the sense of willingness to invest in the securities market and to accept negative returns when investing. Risk appetite varies per individual and per moment of assessment, given that changing macroeconomic factors play a role in one's appetite.

Despite the relevance of this topic and the growing academic literature about the Brazilian securities market[20], investment advisory remains as a significantly unexplored topic in the academia, reason why, on one hand, researching this market is a hard endeavour and, on the other hand, this work's outputs are unprecedented by describing the main hiring conditions of investment advisors and identifying the incentives arising therefrom.

Although investment advisors currently receive significant press coverage, the existing sources regarding their compensation conditions are limited to press articles and documents produced by the market agents themselves, therefore, lacking detailed and academic approaches, as verified in preliminary research[21]. Therefore, either due to their complexity or to their allegedly sensitive nature, details about advisors' payment conditions are usually limited[22].

To illustrate the lack of easily accessible information about the incentives of investment advisors, only in mid-2020 did a major investment platform, XP *Investimentos*, decide to disclose some information on how advisors are remunerated in the distribution of investment products related to investment funds, after a notorious dispute with Brazil's biggest private bank, *Itaú Unibanco*[23]. Even though, the structure of investors' fees has been kept undisclosed throughout the market, with some recently calling out for a more transparent approach (Magnavita, 2023).

Even considering the extensive discovery in a leading merger review case related to this market, the Brazilian Competition Agency (*Conselho Administrativo de Defesa Econômica*, or "CADE" for its Portuguese acronym) made very brief and unconclusive assertions about the criteria commonly adopted by

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20 See, *e.g.*, Mattos Filho (2015), Noda (2015), and Costa (2018).

21 The lack of academic works about this issue, especially from Brazil and with the same perspective adopted herein, was confirmed by the author's preliminary research on October 2020, in the online research databases HeinOnline, Ebsco, JSTOR, SSRN, Google Scholar and Revista dos Tribunais, with English and Portuguese search terms related to this topic, specifically: "*agentes autônomos de investimento*", "*assessor de investimento*", "investment agent", "financial advisor" and "investment advisor".

22 The author's preliminary research confirmed that the information available about the payment conditions of investment advisors is shallow, since it only indicates that advisors can be paid according to fix rates between 0,5% and 1,0% of the investor's annual wealth or based on variable rates, known as rebate fee ("*taxa de rebate*"), linked to the type of investment product sold to the client or to the amount of investment transactions executed in the platform. See Oliveira (2020), Torres and Bertão (2020b), Bessa (2020) and Wiltgen (2020).

23 See: <https://valor.globo.com/financas/noticia/2020/05/13/xp-investimentos-vai-abrir-remunerao-de-agenteautnomo-na-venda-de-fundos.ghtml>

market players to remunerate investment advisors[24]. Although this was not the focus of the merger review investigation, the relation between advisors and digital investment platforms was part of the fact-finding phase conducted by CADE and no detail on how an advisor's fee can vary per investment product was asserted.

The difficulty in having in-depth information about advisors' payment conditions is understandable, given that these are private sector professionals and, therefore, do not have a duty to disclose their payment conditions to the public in general. However, it is arguable that investors have a right to know their advisor's payment conditions, even though such advisor is remunerated by the brokerage firm under non-disclosed terms.

Thus, in relation to advisors' compensation conditions, the market lacks transparency. In a situation where no source presents methodologically assertable data about the object of study, not even in a general way, the remaining alternative is to seek such data empirically[25]. Naturally, given the non-disclosed nature of compensation conditions and the culturally confined way through which this type of subject is socially addressed in Brazil, approaching market players in view of this information was a difficult task.

The author's attempts to access information about investment advisors' hiring conditions in Brazil demonstrate the challenges in finding empirical data about this market. The first empirical method in the attempt of accessing and analysing corporate documents was contacting market participants and re-

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24 "Investment advisors are paid exclusively on commission, thus, they receive fees per amount invested by clients through the brokerage firm's account, without a fixed remuneration. Therefore, the income of these agents is intimately linked to the volume of investments render in the platform." Technical Statements nº 24 of the Brazilian Competition Authority's General Superintendency in the merger review case nº 08700.004431/2017-16, 27/12/2017, § 209, regarding the transaction between major bank *Itaú Unibanco* and major brokerage firm XP *Investimentos* (author's translation; originally in Portuguese: "Os AAIs *são remunerados exclusivamente por comissionamento, ou seja, recebem fees por volume captado para a corretora com que trabalha, sem remuneração fixa. Assim, a remuneração desses agentes está intimamente relacionada com o volume de negócios que a plataforma proporciona.*").

25 Research about a certain market practice can be conducted by primary sources – *i.e.*, sources that result directly from the facts under study, thus being a documentation of those facts – and/or by secondary sources – *i.e.*, perspectives of third parties about the facts under analysis, thus being only an indirect result of such facts. To rely on the more empirical and unprecedented sources of advisors' hiring conditions, this research was mainly based on corporate documents as primary sources.

questing voluntary disclosure of information for academic research purposes. During June and July of 2021, the author contacted, by telephone and e-mail, a total of 34 people and firms, whose identities are kept undisclosed.

The contact information of these individuals and firms were obtained by the author through either personal intermediaries or public information available in Ancord's certification database[26], where contact information of advisors was displayed for the general public. In this database, to obtain a reasonably diverse and unbiased pool of information, the author contacted both advisors who operated as individuals (*i.e.*, on a standalone basis) and advisors who operated as associates in advisory firms, encompassing the following regions of Brazil – Bahia, Distrito Federal, Paraná, Rio de Janeiro, Rio Grande do Sul, and São Paulo.

During these attempts, only one market participant shared a corporate document, specifically, an internal draft of agreement between advisor and brokerage firm, without identifying either party. The other consulted market participants (mostly investment advisors, although some brokerage firms were contacted as well) either did not respond to the author's attempt of communication or refused to provide any information, alleging confidentiality or lack of access to the requested information.

As the number of market participants who shared corporate documents demonstrates (only one out of 34), accessing primary sources from the Brazilian investment advisory market is highly challenging, especially through voluntary communication with market players. In a way, as mentioned above, the difficulty in accessing corporate documents regarding remuneration is understandable, given the expected discretion with which people usually approach this topic. However, this difficulty is, *per se*, a research finding, since it reveals the resistance of market players to disclose information that can be relevant for investors in general, raising information barriers for newcomers to this market.

To bypass these challenges in accessing information on advisors' compensation conditions, alternative methods were used during this research. The second method was the creation of an investment account at a major brokerage firm in Brazil. However, through this account, the author did not succeed in gathering more detailed data about hiring conditions and only managed to access the standard agreement commonly submitted to the firm's clients when

[26] The Ancord database of certified investment advisors was accessed through the following URLs: <http://54.209.169.151/ancord/forms/cadastrogeral/consultageral.aspx> and <https://credenciamento.ancord.org.br/index.html#>

opening the account. The author also pursued police investigations and criminal law proceedings related to advisors before the Brazilian law enforcement authorities, but, since these are usually (though not mandatorily) subject to secrecy, no additional documents were accessed in this attempt[27].

Furthermore, on December 2021, based on the Brazilian Law of Public Information Access (Federal Law nº 12.527/2011), the author requested access to an administrative proceeding in which the Public Consumer Protection Foundation of the State of São Paulo (Procon-SP), a consumer protection agency, applied fines to a major brokerage firm for alleged abusive conduct towards consumers[28]. However, the author's request was denied by the institution's executive board, on the basis of secrecy of the administrative proceeding, under the terms of the reply issued to the author on 10 January of 2022.

The most successful method of accessing unprecedented documents about this market was research on judicial disputes involving investment advisors, on digital databases of a key Brazilian court, where real agreements between brokerage firms and investment advisors remained unnoticedly available to public access. The chosen court database was São Paulo's State Appellate Court's, encompassing both lower-court and appellate-court records.

The São Paulo court was chosen as the most adequate due to being the Brazilian state where the largest advisory firms and brokerage firms are based, as well as, according to Ancord's database, where most advisors operate in Brazil[29]. These elements indicated that this state court was the most likely to

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27 On 31 December 2021, the author launched search terms related to investment advisors ("*agente autônomo de investimento*" and "*agentes autônomos de investimento*") in São Paulo's Appellate Court's case-law database, through the following filters of subjects: Crimes against patrimony, Crimes against the National Financial System, Crimes against the economic order, Crimes against consumer welfare, and Crimes against the securities market. No search results appeared under this search criteria. Moreover, the same search terms were used in the online database of Brazil's Federal Public Attorney's Office (*Ministério Público Federal* – https://apps.mpf.mp.br/aptusmpf/portal?servidor=portal), on 05 December 2021, but no search results turned up as well. To conclude, on 31 December 2021, the same search terms were used, along with the term "churning", in the general database Jusbrasil, having appeared only two court decisions from the Federal Court of the 4th Region and one court decision of the Federal Court of the 3rd Region.

28 See <https://www.procon.sp.gov.br/procon-sp-multa-xp-investimentos/>

29 According to Ancord's database, in September 2021, 41,93% of the investment advisors in Brazil resided in the State of São Paulo. This is, by far, the highest concentration of investment advisors in a single Brazilian state, considering that, in the State of Rio de Janeiro, which is placed in second in terms of number of certified advisors, only 10% of all advisors in Brazil reside in the region, while all the remaining Brazilian states concentrate quantities

encompass the vast majority of legal disputes involving investment advisors, both in quantity and in relevance of market representation.

The research revealed that, in some disputes between brokerage and advisory firms, the agreement executed between them is attached to the case files as an exhibit, reason why it is publicly accessible[30]. By researching case files of various judicial proceedings involving advisory firms, 10 contracts were found, regarding eight different lawsuits, under a total of 87 search results[31].

Based on the methods described above, the following types of corporate documents were analysed: (i) agreements executed between investment advisory firms and brokerage firms, (ii) draft of agreements, (iii) standard contracts between investors and brokerage firms, and (iv) compliance policies applicable to investment advisors. Only publicly accessible documents were used as sources. This amounted to a total of 17 (seventeen) corporate documents, as detailed below[32]:

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lower than 10%. Data available in: <https://credenciamento.ancord.org.br/index.html> Access on: 25/09/2021. More recent data not available.

30 Considering that, according to the regulation then in force (article 8, § 1, of Regulation CVM nº 16/2021), the official name of every advisory firm must contain the term "*agente autônomo de investimento*" (Portuguese term for "autonomous investment agent"), the author used this term, in its singular and plural variants, to search for pertinent judicial proceedings, by filtering the name of involved parties, on 21 and 25 July 2021. To delimitate the search results, additional filter was later applied, namely, the jurisdiction of the central region of São Paulo ("*Foro Central Cível*"), where the two sections specialized in corporate litigation and arbitration disputes operate and precisely where contractual disputes between advisors and brokerage firms tend to be allocated for judgement.

31 The agreements were extracted from the case files of the following judicial proceedings of São Paulo's court jurisdiction: 1009067-31.2021.8.26.0100, 1019537-92.2019.8.26.0100, 1053342-02.2020.8.26.0100, 1056040-44.2021.8.26.0100, 1057162-92.2021.8.26.0100, 1063606-54.2015.8.26.0100, 1071066-19.2020.8.26.0100 and 1126564-71.2018.8.26.0100.

32 Considering that the draft of agreement is not an undisclosed document and that it was not necessarily executed between market participants – although its provisions may have served as basis for real market negotiations, its content is not legally binding –, it was dismissed as a primary source for this study. The following agreements were effectively analysed and taken into consideration for this book: Agreement between *Banco BTG Pactual* S.A. and *Porte Agente Autônomo de Investimentos Ltda.*; Agreement between *Banco BTG Pactual* S.A. and *Confiança Agente Autônomo de Investimentos Financeiros S/S Ltda.*; Agreement between *Walpires* S.A. *Corretora de Câmbio, Títulos e Valores Mobiliários* and *Soldi Agentes Autônomos de Investimentos Ltda.*; Agreement between XP *Investimentos* CCTVM S.A. and *Ação Investimentos – Agente Autônomo de Investimento Sociedade Simples*; Agreement between XP *Investimentos* CCTVM S.A. and *Acqua – Agente Autônomo de Investimentos Ltda.*; Agreement between XP *Investimentos* CCTVM *of* S.A. and CDR *Agentes Autônomos de Investimentos Ltda.*; Agreement between XP *Investimentos* CCTVM S.A. and *Confiança Agente Autônomo de Investimentos Financeiros S/S Ltda.*; Agreement between XP *Investi-*

**Table 1 – Overview of corporate documents reviewed during research**

| Type of document | Number of documents analysed |
|---|---|
| Agreements executed between advisors and brokerage firms | 10 |
| Draft of agreement between an advisor and a brokerage firm (dismissed) | 01 |
| Standard contracts between investors and brokerage firms | 02 |
| Compliance policies of brokerage firms | 04 |
| **Total** | **17** |

Adding to the document review, the author resorted to exclusive expert interviews, with the objective of gaining practical perspectives about the investment advisory market and the effects of advisors' compensation conditions over investors. The interviews were conducted on August 2021 and February 2022, after approval by FGV's Ethical Committee on Research Involving Human Beings (CEPH-FGV)[33].

To obtain a reasonable plurality of views about the object of study and avoid biased conclusions, the choice of interviewees considered their different backgrounds and roles in the securities market, as demonstrated by their description below. Before each interview, the author submitted a term of consent to the interviewee, with the terms endorsed by FGV's ethical committee, including the possibility of identity confidentiality.

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*mentos* CCTVM S.A. and *EuQueroInvestir Agentes Autônomos de Investimentos S/S*; Agreement between XP *Investimentos* CCTVM S.A. and *Marcelo Galvão Morroni – Agente Autônomo de Investimento* – EPP; Agreement between XP *Investimentos* CCTVM S.A. and *One Agentes Autônomos de Investimentos Ltda.*; Standard Intermediation and subcustody agreement between *Bradesco* S.A. *Corretora de Títulos e Valores Mobiliários* and its clients; Intermediation and custody agreement between XP *Investimentos* CCTVM S.A. and its clients; Compliance policies: "*Manual de Procedimentos e Supervisão de* AAI" from BTG *Pactual*; "*Política de Compliance*" from XP *Investimentos*; "Política para Agente Autônomo de Investimentos" and "Política de Princípios Éticos, Regras de Conduta e de Atuação dos Colaboradores" from *Órama* DTVM.

[33] The approval by FGV's Ethical Committee on Research Involving Human Beings (CEPH-FGV) to the author's proposed research method of expert interviews was ratified through Opinion nº 178/2021 in CEPH-FGV's plenary session.

The interviews were conducted on a semi-structured form, *i.e.*, based on previously drafted questions, notwithstanding improvised inquiries during the interviews according to their own individual development. The questions were not necessarily about legal issues, given that some of the interviewees had not graduated in Law. Although the interviews were conducted verbally, each interviewee received a report with their interview's takeaways for their approval or amendment. This allowed for their participation in the interpretation of their answers, avoiding dubious or unclear statements.

As for the interviewees' identities and their roles in the securities market, a total of eight experts in Brazil were interviewed[34]. Three of them required confidentiality, specifically, (i) a founding partner of a major investment advisory firm, (ii) an advisor associated to a small-sized advisory firm, and (iii) an investment analyst of a banking institution. The other interviewees were the following:

- Alexandre Costa Rangel – Former consultant at the OECD, then commissioner in office of the Brazilian Securities Commission, attorney under the Brazilian Bar Association, former advisor of the appellate body of the Brazilian Monetary Authority (*Conselho de Recursos do Sistema Financeiro Nacional*) and graduated in Law from Rio de Janeiro's State University (UERJ).
- Caio Mendes Burti – Partner of the brokerage firm XP *Investimentos*, leading the teams of Performance and B2B Projects.
- Gustavo Machado Gonzalez – Former commissioner of the Brazilian Securities Commission, attorney under the Brazilian Bar Association, and law professor at the *Insper Institute*.
- Henrique Machado – Former commissioner of the Brazilian Securities Commission, attorney under the Brazilian Bar Association, former attorney-general and former deputy executive secretary of the Brazilian Central Bank, former Secretary of the National Monetary Council, former Chief Advisor of the Subprosecutor-General of the Republic, and, currently, an investor.
- Joaquim Paiffer – Founding partner and president of the board of directors of *Atompar* and manager of *Paiffer Management*.

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[34] The conclusions defended in this book do not necessarily reflect the interviewees' views or that of the institutions to which they are related.

In addition, although not interviews, the author also approached servants of the Brazilian Securities Commission, to accompany a public consultation pertinent to this study, and the market-regulated oversight board of Brazil's stock exchange (*BM&F Bovespa Supervisão de Mercados* – "BSM"), for clarification about the methodology behind their public database.

## 2. Fast-paced transformation and investor behaviour in the securities market

Recent peculiarities indicate that the Brazilian securities market has been experiencing a unique transformation. For example, during the Covid-19 pandemic, while Brazil's Gross Domestic Product (GDP) suffered a record loss[35] and the public debt experienced an unprecedented rise[36], the Brazilian securities market appeared to be immune to the macroeconomic crisis, in an apparently countercyclical phenomenon: the daily trades and the entrance of new individual investors achieved record amounts in the Brazilian stock exchange[37]. Also during the pandemic, Brazilian startups received record investment funding, part of which took place through the securities market[38].

Other elements that suggest a new stage of the securities market is the digitalisation of financial services and the entrance of platform-based players in the financial sector (fintechs), boosting innovation for consumers. The changing behaviour of consumers, who adhered to digital tools as means of investing and consuming financial services, and the entrance of conglomerates of known digital markets into this sector – the so-called "big techs", such as

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35 The Brazilian GDP suffered a record loss of 4,1% in 2020. See at <https://istoe.com.br/pib-do-brasil-tem-queda-recorde-de-41-em-2020/> Access on: 13/11/2022.

36 According to Brazil's Federal Accounting Court ("TCU", for its Portuguese acronym), the federal public debt of 2020 surpassed the value of BRL 5 trillion. See at <https://portal.tcu.gov.br/imprensa/noticias/divida-publica-federal-passa-de-r-5-trilhoes-em-2020.htm> Access on: 13/11/2022.

37 In part due to the drop of interest rates and the widespread allocation of investments from government bonds to the securities market, the Brazilian stock exchange (B3) had a record of daily capital flow in 2020, in the average value of BRL 26 billion (nearly € 5 billion) per day, and a record of individual investors, amounting to over 3.2 million individuals registered as investors. These are extremely high numbers, especially considering the unprecedented scenario of a global pandemic, even though the number of registered individual investors considers the same individual more than once if he or she has an investment account in more than one brokerage firm.

38 In 2021, the investments in Brazilian startups amounted to around BRL 50 billion. See <https://olhardigital.com.br/2021/12/31/pro/com-recorde-de-investimentos-em-startups-brasil-ganhou-dez-unicornios-em-2021/>

Google Pay, Apple Pay and WhatsApp Pay –, indicate that the market is experiencing fast-paced innovation and changes in its structure. The investment advisory market is part of this phenomenon.

Knowing the structure and functioning of a market is the first step to understand legal issues concerning it. The intense transformation that the Brazilian securities market has experienced over the last years brings relevant challenges for investor protection efforts. Some of these challenges can include the risk of overenforcement (*i.e.*, excessive regulatory intervention or so-called "type I errors") or underenforcement (*i.e.*, insufficient regulatory intervention or so-called "type II errors") due to concerns of undermining innovation, excessive optimism of investors, and undergoing changes in market structure, which may deviate oversight and challenge regulators to identify market failures that bring risk to investors, such as conflict of interests of intermediary service providers.

Although the securities market is complex and unknown to many citizens, its functioning has a simple background. It is a market of interaction between investors – those who save resources to invest – and entrepreneurs or issuers – those who seek third-party resources to develop their own economic activity (CVM, 2017, p. 36). In this market, the core product subject to trade between these participants is investment products issued by the entrepreneur. Such products are assets that allow its owner (the investor) to obtain capital and rights related to the issuer's economic activity.

According to the Brazilian Association of Financial and Securities Markets – Anbima (2019a, p. 07), investment products are "securities and financial assets defined as such by the Brazilian Securities Commission and/or by the Central Bank", giving it, thus, a broad concept according to what these regulators define as investment products[39].

Generally, an investment product is a way through which individuals and legal entities invest, *i.e.*, allocate their funds to obtain more funds (what experts tend to call "capital return"). Considering that investment products have such a wide concept, this book focuses on securities, which are subject to the jurisdiction of the Brazilian Securities Commission. Examples of such investment products in Brazil include company stocks, shares of investment funds, banking depositary receipts, securities related to agribusiness or real estate (locally known as "LCA" and "LCI", respectively).

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[39] Author's translation from the original Portuguese excerpt: "(...) *valores mobiliários e ativos financeiros definidos pela Comissão de Valores Mobiliários e/ou pelo Banco Central do Brasil*".

Differently from other industries, investment products can be better understood as assets that grant rights to the holder (investor), as a result of intermediary services that connect issuers to investors. Though occasionally represented by paperback or electronic documents, investment products are not properly manufactured products, such as smartphone devices or cars[40]. The reason for that is the structure of the securities market: investors can only access investment products through intermediaries, who connect issuers and investors by providing a wide variety of services to these market participants (services such as underwriting, advisory, and rating analysis). Therefore, to enable the acquisition of these products by investors, their distribution and trade is intermediated by various service providers, who are explicitly mentioned in the Brazilian Securities Act (Law nº 6.835/1976)[41].

This intermediation is mandatory regardless of who offers the investment product. Securities can be offered by issuers – *i.e.*, those responsible for issuing the security and putting it into the market, such as the company that offers its stocks or the fund that offers its shares – or by investors who had originally acquired those securities and now pursuit other investors to acquire them, which, experts say, provides "liquidity" to the market. When the product is offered by its issuer, the exchange takes place in the primary market, while the trade between investors takes place in the so-called secondary market (Noda, 2015, pp. 17-8)[42].

One of the main intermediaries that operate in this ecosystem are investment firms, which, in Brazil, encompasses two types of firms: brokers and distributors – along this book, they are indistinctively referred to as brokerage firms or investment platforms. While their formal denominations differ from one another and their governing regulation are not the same[43], they are both regulated by the Securities Commission and the Central Bank in Brazil. Most importantly, brokers and distributors perform the same basic roles for investors,

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40 This remark was also made by CADE's General-Superintendency, in its Closing Statements nº 24/2017 (p. 4, footnote nº 3) for the merger review case nº 08700.004431/2017-16 (parties: Itaú Unibanco S.A. and XP Investimentos S.A.).

41 Article 15 of Law nº 6.385/1976.

42 This study analyses both markets (primary and secondary) indistinctively, considering that the practices of investment advisors and the legal issues concerned do not vary significantly between them. Additionally, during the normative overview conducted for this research, no rules providing different standards for advisors in each of these two markets were identified.

43 While brokers are regulated by Ordinance-CVM nº 402/2004, distributors are regulated by Regulation-CMN nº 1,120/1986.

such as trading securities on behalf of clients, operating in the stocks exchange, providing advisory and technical assistance to investors, and administrating investment accounts, among other activities[44] (CVM, 2019a, p. 261).

Thus, the range of activities performed by brokerage firms is wide in scope, encompassing roles that implicate different levels of intervention in the investor's decisions – *i.e.*, from technical assistance to administration of investment accounts, depending on the hired services. To invest in the Brazilian securities market, the investor must sign an agreement ("*contrato de corretagem*", as called locally) and create an account at a brokerage firm, granting representation powers to the brokerage firm toward official trading systems.

This framework leads to a threefold relation between the three market participants mentioned above, namely, investors, brokerage firms, and issuers, especially in the context of primary markets. While the investor seeks rewarding products to invest in, the issuer works to sell as many securities as it can and under the most favourable conditions. Considering that the securities market is structured in a way as to unable issuers and investors from trading directly between themselves, brokerage firms serve as a meeting point between these two market participants, forming a threefold relation.

The investment platforms that brokers operate are digital places where issuers offer their products and investors make their investments. Issuers that want to have their products available in a broker's investment platform pay a fee to the broker, which can vary per issuer, due to, *e.g.*, bargain power, performance and reputation among investors (Seabra, 2023).

Traditionally, investment products used to be offered by large banks, aimed to either corporate clients or wealthy individuals, through closed platforms, meaning that all or the vast majority of the offered products were issued by the bank, entities of the same economic group or funds managed by the bank's asset management (BCB, 2019, pp. 6-7; Bessa, 2020). In other words, issuers and brokerage firms were commonly linked by corporate ties, limiting the variety of products available to investors (CADE, 2017, p. 13), reason why these arrangements are known as closed platforms.

Over the last years, however, the ecosystem of investment products experienced profound transformation. As indicated above, the number of individual investors increased significantly in Brazil, along with their growing interest in investment products. In a phenomenon commonly attributed to the brokerage

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[44] The roles of these two types of firms came closer together after the Joint Decision nº 17/2009, issued by the CVM and the Brazilian Central Bank, allowing distributors to operate directly before the stocks exchange's trading systems.

firm XP *Investimentos*, although not exclusive to it, more investment platforms adopted an open framework by offering various issuers' products, leading to higher inter and intraplatform competition among brokerage firms (Anbima, 2019b, p. 4; CADE, 2017, § 134).

This business model based on an open framework resulted from digitalised and non-verticalized brokerage firms, which lowered the costs to access investment products and increased the diversity of options for investors, through brokerage platforms that operate like a shopping mall or a supermarket of investment products (BCB, 2019, p. 2; Bessa, 2020). To illustrate, nowadays, digital mobile apps are the main investment tool in Brazil (46% of investors), although in-person bank relationship remains as a significant form of investment (38%) (Anbima, 2023, p. 18). Naturally, this made banks run for greater diversity of investment products offered in their own brokerage platforms.

This ecosystem in which brokerage firms offer their services to both issuers and investors configures a two-sided market, with network effects, *i.e.*, the efficiency and attractivity for one side of the platform (*e.g.*, investors) increases with higher platform-adhesion of the other side (*e.g.*, issuers) (Pereira Neto & Casagrande, 2016, p. 33). Thus, the business model of these platforms is based on a pursuit to offer conditions that are capable to attract both groups, through a cost allocation that bears each group's interests or maximizes well-being in the platform (Rochet & Tirole, 2003, pp. 1.012-1.013).

Given these network effects, to have a successful business model, brokerage firms have incentives to serve the demand of both sides of their platforms: investors and issuers. The more investors enter the platform, the higher the consumption of investment products will be; meanwhile, the more issuers enter the platform, more competition between issuers will take place and more options of products will be available at better conditions, favouring investors. Thus, these are mutually fostering demands.

At a first glance, a business model that is based on balancing the interests of more than one group in the platform is incompatible with conflict of interests, since conflicting with the interests of one side can undermine the entire business and the balance that supports the platform. However, if the platform operator has greater incentives to favour one side of the platform in detriment of the other and the unfavoured side lacks sufficient awareness and bargain power, the platform could suffer from structural conflict of interests. This is later approached in chapter III.

Zooming in this business, one notices that investment platforms are not limited to two sides solely. Investment advisors come in scene and appear as an additional group in these platforms, meaning brokerage firms actually operate as multisided platforms. The flow of investment products in a given platform tends to be higher as more advisors, investors and issuers operate in it. Although brokerage firms can operate with investors directly in the retail sector – *i.e.*, without advisors –, brokerage firms have been resorting to advisors to assist and pursuit their clients.

This ecosystem of investment platforms, in which the investment advisory market operates, has been experiencing intense transformation, context in which, on one hand, investment advisors are put into the spotlight while, on the other hand, tuning the right regulatory approach to problems such as occasional conflict of interests becomes harder to assess. Different from markets in theory or in the books, markets in real life operate on the basis of constant interactions between players and experience constant change. To reveal the true aspects of the Brazilian investment advisory market, the subsections below explore the market structure, the profession rules applicable to advisors and the investors' behaviour as driving factors to position advisors as influencing players.

### a. Market structure

Despite the repercussion of market moves made by leading advisory firms over the last years, the structure of the advisory market in Brazil lacks a systematic overview, given that the mergers and acquisitions that alter the structure of this market are commonly reported by the press, in a decentralized and non-systematic manner. To fill in this gap, a list of these transactions is provided below[45].

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[45] To identify these transactions, the author conducted research on two stages. Initially, search terms were used in CADE's digital databases to identify transactions that were subject to antitrust scrutiny. On June 05, 2021, the author used the search terms in three different databases: online section of digital publications for the Official Gazette (access), online section of public research of SEI-CADE (access), and CADE's case-law system (access). At the online section of digital publications, the category "*edital*" was used as filter for types of documents and no filter of dates were used. At the online section of public research, the categories related to merger review proceedings were applied as filters for types of proceedings, without any filter of dates. At the online case-law system, no search filter was used, except for the search terms related to investment advisors and their activity's registration code in Brazil's Geography and Statistics Institute (IBGE). No transaction was found. Considering that many transactions may not be subject to antitrust scrutiny, under the

In two recent years when transactions involving advisory firms were in the spotlight, at least 11 transactions took place, including mergers and acquisitions between advisory firms and between these and brokerage firms, concerning the main players of this sector.

**Table 2 – Overview of mergers and acquisitions involving investment advisory firms, in the timeframe of 2020-2021**

| Year | Type of transaction | Players involved | Value under advisory |
|---|---|---|---|
| 2021 | Acquisition of an advisory firm by a competitor. | Eu Quero Investir (EQI)<br>New York Capital | BRL 300 million (Estadão, 2021) |
| 2021 | Associative contract between a brokerage firm and an advisory firm. | XP Investimentos<br>Messem Investimentos | BRL 15 billion (Júnior, 2021) |
| 2021 | Creation of a new brokerage firm through the partnership between an existing brokerage firm and an advisory firm. | BTG Pactual<br>Acqua-Vero | BRL 8,3 billion (Cotias, 2021a) |
| 2021 | Merger between competing advisory firms. | Monte Bravo<br>New Capital | Not available |
| 2020 | Creation of a new brokerage firm through the partnership between an existing brokerage firm and an advisory firm. | BTG Pactual<br>Eu Quero Investir (EQI) | BRL 09 billion (Cotias, 2021a) |
| 2020 | Acquisition of an advisory firm by a competitor. | Monte Bravo<br>Ella | Not available |
| 2020 | Acquisition of an advisory firm by a competitor. | Monte Bravo<br>MN Investimentos | Not available |
| 2020 | Creation of a new brokerage firm through the partnership between an existing brokerage firm and an advisory firm. | BTG Pactual<br>Lifetime Investimentos | BRL 02 billion (Cotias, 2021a) |

thresholds established in Law nº 12.529/2011 and in the Interministerial Ordinance MJ/MF nº 994/2012, the second stage involved using pertinent search terms in general search engines and in press websites, including Google News, on June 05, 2021.

| 2020 | Creation of a wealth management firm through the partnership between an existing brokerage firm and an advisory firm. | BTG Pactual Arton Advisors | BRL 1,8 billion (Setti, 2021) |
|---|---|---|---|
| 2020 | Merger between competing advisory firms. | Acqua Vero Investimentos | BRL 08 billion (Forbes, 2020) |
| 2020 | Merger between competing advisory firms. | Faros Investimentos Private Investimentos | Not available |

Source: Author's creation.

Along with these transactions, other more recent ones are shaping this industry. Some advisory firms have grown to the extent of either growing an equivalent bargain power toward the brokerage firm to which they are related or founding their own brokerage firms, most of which are just beginning to operate[46]. In parallel, after a boost in the use of advisors to increase market share and access to investors during the last years, some brokerage firms have intensified the use of alternative distribution strategies in place of advisors, such as brand marketing and hiring of experienced investment banking professionals (Cotias, 2021b).

As further reinforced by research elements presented in the following sections, investment advisors have grown to the extent of becoming more relevant players in the game of catching clients (*i.e.*, investors). In a certain sense, advisors – some key firms, at least – have gained greater thirst for autonomy in their relationship with brokerage firms, who, on the other hand, are traditional cardholders in the chain of investment product distribution[47].

An example of this thirst for autonomy is the recent model of hiring advisory firms by brokers according to which both become partners in the creation of a new brokerage firm (Ragazzi, 2020), such as some of the transactions men-

[46] According to press coverage, seven advisory firms are developing their request proceedings before the Securities Commission and the Central Bank, namely, Monte Bravo, Messem, Faros, Blue3, Nomos, EQI, and Acqua Vero. See <https://maisretorno.com/portal/assessorias-de-investimento-correm-para-lancar-corretoras-em-2023>

[47] Investment advisors are not technically intermediaries of the securities market, because they operate on behalf of brokers, while the Brazilian regulations qualifies intermediaries as those who can act on their own behalf or that of third parties to trade securities in the regulated market (article 1, I, of Directive CVM nº 505/2011).

tioned in table 2 above. Another example is the decision of some advisory firms to not distribute a certain investment product of the brokerage firm to which they are related, demonstrating a clear exercise of autonomy[48].

Some experts have asserted the recent growth of the Brazilian advisory market as well as the enhanced autonomy of some advisors towards other players of this ecosystem. According to Gustavo Machado Gonzalez (Favoretto Rocha, 2022, p. 41), attorney and former commissioner of the Brazilian Securities Commission, the changes in advisors' role – or on the perception of this agent's role by other market participants – does not seem to have resulted from a change in the nature of their activities, but rather a profound change in the size and importance of these firms. This allowed them to have greater autonomy toward other players, at least in economic terms, since, legally, advisors are still attached to a brokerage firm to operate in the securities market.

Still according to Mr. Gonzalez, this phenomenon remains clear by the fact that, over the last years, some of the biggest advisory firms pursued an exemption to the regulatory obligation of exclusivity towards their hiring broker (in force until the recent Reg. 178), by, for example, attempting to create their own brokerage firms.

In summary, the market of investment advisors has experienced undeniable growth in Brazil. This phenomenon has many facets, among which the growing competition between brokerage firms and banking institutions, and even the discontent of individual associates who allege abusive hiring conditions from major advisory firms, such as excessively broad non-compete clauses and heavy contractual fines[49]. To what concerns this book's focus, it should be highlighted that the recent transactions involving high investment amounts and the most known advisory firms, together with the entrance of new digital platforms in the market, demonstrate that the ecosystem of investment product distribution and the advisory market are under intense transformation.

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48 The decision of the advisory firms EQI and B.Side to not distribute CRA assets of the Madero Grupo from the broker BTG Pactual's investment platform to clients was reported by Cotias and Pinto (2022).

49 *E.g.*, see <https://valorinveste.globo.com/produtos/servicos-financeiros/noticia/2022/11/21/assessores-de-investimentos-brigam-para-conseguir-sair-de-escritorios-ligados-a-corretoras.ghtml> and <https://valorinveste.globo.com/produtos/servicos-financeiros/noticia/2023/03/07/apos-se-frustrarem-com-plataformas-de-investimentos-assessores-voltam-para-grandes-bancos.ghtml>

## b. General rules of the advisory profession

The second aspect that has changed over the years is the rules of advisory profession. Based on a detailed mapping of all rules applicable to advisors during the last decades, the first finding that stands out is the fact that investment advisors are not new characters in Brazilian law, as noticed by the 1967 Regulation CMN nº 76. This was the first norm to mention investment advisors in Brazil, meaning these agents have been under the scope of Brazilian market regulators for decades already.

In the 2000s, the Brazilian authorities – namely, the Securities Commission and the National Monetary Council ("CMN", for its Portuguese acronym) – issued the first rules dedicated exclusively to regulate investment advisors in their various aspects and operation (Regulation CMN nº 2.838 of 30 May 2001 and Directive CVM nº 352 of 25 June 2001). Until then, advisors were regulated by multiple sparse norms that addressed other topics, mentioning advisors only laterally[50].

The issuance of norms dedicated exclusively to regulate advisors, decades after their first normative reference, indicates the increase in the level of regulatory requirements and mandatory legal standards for this line of profession, and, most importantly, an effort of regulators to understand and regulate these agents. This fact is noticeable by the Brazilian Securities Commission's recent calls for contributions about regulatory reform on investment advisors. In 2019, the CVM conducted the *Audiência Pública SDM nº* 03 and, in 2021, the *Audiência Pública SDM nº* 05, approaching different issues related to advisors' role and their interaction with investors and brokers, such as the end of mandatory exclusivity between advisors and their respective brokerage firms for the distribution of securities in the Brazilian market.

Some may argue for the constantly changing nature of law and, thus, that it is only natural that regulated professions suffer changes in their applicable rules over the years. Indeed, this nature of law is enhanced in a dynamic environment such as the securities market and can explain, at least partially, the regulatory reforms of investment advisory in Brazil. However, there is more to this timeline of reforms than just the changing nature of law.

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[50] The first norm dedicated to regulating investment advisors was Regulation CMN nº 238/1972, but it was issued prior to the creation of the Brazilian Securities Commission and it did not address as many aspects as Regulation CMN nº 2.838/01 and Directive CVM nº 352/01. In other words, while the Regulation CMN nº 238/1972 was in force, advisors still relied on other norms and various aspects of their profession remained unregulated.

The complexity of advisors' role in the market grew over the years. Initially, the profession of advisory was conceived as only exercised by individuals (item VI of Regulation nº 76/1967) and, as the years went by, in 2001, advisory became formally accepted through non-corporate legal entities ("*pessoa jurídica uniprofissional*", pursuant to article 1 of Regulation nº 2.838), conditioned to the entity's activity being solely investment advisory.

This type of requirement, where any other activity is prohibited and associates must be registered professionals in the entity's field, is typical in fields where, in theory, the activity's intellectual aspect surpasses its business-managerial aspect – in other words, regulators assume the player's greater dedication to the intellectual dimension of the activity rather than to the management of risk and resources for profit. This is the case, for example, of attorneys in Brazil, whose federal regulation forbids law firms to provide any other service besides legal advisory services or associates without a national bar registration[51].

Despite this condition that stood for decades, the recently enacted Reg. 178 shifted advisors' regulatory framework by admitting advisory firms under corporate form, allowing shareholders who are not legally qualified advisors. Both normative milestones – the admission of non-corporate legal entities, in 2001, and corporate entities as well, in 2023 – can indicate that investment advisors' role in Brazil has become growingly demanded and complex since their first rule in the 1960s.

In the explanatory statement that reasoned a regulatory amendment in 2022, by which the term "legal entity" was include in the definition of investment advisors[52], the Ministry of the Economy's Special Secretary of Treasury and Budget remarked that some advisory firms have reached unprecedented size and level of business, to the extent that some advisory firms operate more assets than many brokerage firms and, therefore, their legal form must adapt to allow compatible capitalization[53].

In addition, one must bear in mind that the use of a legal personality other than the individual who directly performs the activity – in other words, attributing human activity to abstract legal entities – has been a way through

[51] Article 16 of Brazilian federal law nº 8.906/1994.

[52] The Regulation CMN nº 4.982/2022 amended article 1 of Regulation CMN nº 2.838/2001.

[53] Opinion nº 05/2022-CMN issued by secretary Esteves Pedro Colnago Júnior, on 17 February 2022: Available in <https://www.bcb.gov.br/pre/normativos/busca/downloadVoto.asp?arquivo=/Votos/CMN/20225/Voto_do_CMN_5_2022.pdf>

which the law enabled complex economic activities over the centuries (Cordeiro, 2000, pp. 9-10), even though, currently, legal entities can be used for small businesses.

Along with the greater complexity and demand for investment advisory over the years in Brazil, a key historical aspect should not be overseen in the increase of regulatory norms concerning advisors. The 2011 regulatory reform that led to the issuance of Directive CVM nº 497 (no longer in force due to Reg. 178) occurred only a few years after the 2008 subprime mortgage crisis. This global economic crisis gave birth to a new wave of stakeholders' scepticism towards the securities market in general and market intermediaries specifically, including investment advisors. This worldwide phenomenon influenced the Brazilian Securities Commission to tighten the regulation of investment advisors[54].

In summary, the regulatory reforms and various amendments to the norms applicable to investment advisors over the last decades can be interpreted as an effort of the law to accompany the various transformations of Brazil's securities market. While advisors came into the spotlight of Brazil's investors, either with scepticism in earlier years or, more recently, as potential experts that can guide clients in navigating the sea of risks, these professionals became subject to greater regulatory scrutiny by the Securities Commission. This is why the Brazilian investment advisory market has been going through a business and regulatory reorganisation (Costa, 2022).

### c. Investor behaviour

Alongside the market structure and the rules of profession, the investor behaviour is also under intense transformation. The record-breaking increase of individual investors at the Brazilian stock exchange in 2020 and news that investors have changed the way they relocate their funds during the Covid-19 pandemic (Moneylab, 2021) are some elements that suggest a changing pattern of behaviour. According to a survey conducted by the Brazilian stock exchange in 2020, during the pandemic, investors engaged in greater diversification of their investment portfolio and became more resilient to stock fluctuation, compared to previous years[55].

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[54] Assertion based on the testimony of Prof. Otávio Yazbek, who, besides participating in the evaluation board of the master's research that underlies this book, took part in the 2011 regulatory reform when he was a commissioner at the CVM.

[55] Available in <http://www.b3.com.br/pt_br/noticias/investidores.htm> Access on: 12/06/2021

Accordingly, data from Anbima (2021, pp. 13-14) shows that 2020 was the first year in which financial products represented the highest destination of Brazilian people's funds (53%) in comparison to other destinations (real estate, debt, saving money at home, among others). In addition, although banks' savings account remains as the main destination of Brazilians' funds, it had an unprecedented decrease as an investment decision (8% decrease comparing to 2019), while other financial products, such as private equity and investment funds, experienced an increase of investor choice (Anbima, 2021, p. 14).

Additionally, in every level of income, more Brazilians are investing in investment products compared to previous years (Anbima, 2023, p. 15). Despite the constant variation of investors' general risk appetite, Brazilians are more optimistic about the future macroeconomic scenario (Anbima, 2023, p. 9), though not necessarily based on facts.

According to a former CVM commissioner and OECD consultant[56], Brazilian people have gained greater interest for alternative investment products, because their access to it has become less costly in digital investment platforms and their expectations have risen due to the fall of interest rates during the pandemic. According to the interviewee, this is a democratization of the securities market from an investor perspective.

Despite this democratisation in the Brazilian securities market, the average investor in Brazil still lacks minimum expertise in finances, being, thus, overly vulnerable to market risks and to the use of biased advisory service. The lack of financial education among Brazilian people is easily assertable.

For example, according to a report issued by Anbima (2021, pp. 29-33), in a survey that sought to evaluate average Brazilian citizens' basic knowledge in economics and finance, from 20% to 40% of the interviewed citizens provided wrong answers to three questions labelled as elementary[57]. Although the fa-

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56 Interview provided by Mr. Alexandre Costa Rangel to Favoretto Rocha (2022). As indicated previously, Mr. Rangel is an OECD consultant, former commissioner of the Brazilian Securities Commission, attorney under the Brazilian Bar Association, former advisor of the appellate body of the Brazilian Monetary Authority and graduated in Law from Rio de Janeiro's State University (UERJ).

57 The following questions were made to the interviewees, who could choose only one answer among four options, one of which was correct, two were incorrect, and one was "I do not know". Question nº 1: Suppose you have $ 100 in investments that have a total return of 2% per year. After five years, how much money do you expect to have in your account if you have kept the initial amount invested during this period? Question nº 2: Image that the return of your investment is 1% per year and that inflation is 2% per year. After one year, how much do you expect to be able to buy with the money that was kept invested during that

miliarity of Brazilians with investment products has been increasing (Anbima, 2023, p. 16), it is still poor on a macro level.

### d. Intermediary conclusion

Considering the three aspects described above – market structure, rules of profession and investor behaviour –, the ecosystem of investment products has been experiencing intense changes, under both the supply side and the demand side. This fast-paced transformation is relevant to understand the vulnerability of investors against a possibly biased advisory service, given that market transformations tend to shadow underlying weak spots and challenge regulators to balance the right approach[58].

Moreover, although many outcomes of such changing scenario can favour investors' interests, the investors' growing willingness to accept investment risks and the advisors' appetite to grow economically can jointly deepen the investor's information asymmetry and set a favourable environment to biased advisory. Under this context, the advisor interacts with both investors and brokers. To understand the alleged risks of conflict of interests, one must understand these interactions and, afterwards, the advisor's compensation conditions, as detailed in the following chapter.

## III. Serving two kings: The role of investment advisors

This chapter aims to assert whether the usual hiring conditions of investment advisors in Brazil have the potential to generate conflict of interests. Therefore, the sections below (i) explore the roles of advisors and the nature of their relation with other participants of the securities market, (ii) detail the hiring and compensation conditions usually adopted in the Brazilian advisory market, and (iii) analyse what are its risks of conflict of interests.

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period? Question nº 3: Please answer if this assertion is true or false: "Buying stocks from one single company provides a safer return than an equity fund".

58 The experience of regulators in digital markets illustrates the challenges in identifying and addressing issues in markets that are under fast-paced transformation, as detailed by Pereira Neto and Lancieri (2021) in an analysis about remedies applied by competition agencies. Additionally, even after market failures are dully identified, Favoretto Rocha (2020, p. 316) shows how regulators in markets under intense innovation are left with a dilemma between overenforcement and underenforcement.

## 1. The roles of advisors in the securities market

The advisor has always been conceived as an individual, *i.e.*, a single person. However, Regulation nº 2.838 from the CMN provides a broader concept, referring to advisors as either individuals or legal entities[59]. Advisors can, thus, operate in one of the two forms (article 2), having to opt between an individual firm (*i.e.*, a one-associate firm) or a multi-party firm (*i.e.*, when the advisor decides to operate along with at least one other advisor) in case he/she decides to operate as a legal entity.

However, what defines an investment advisor as such is not the legal form under which he/she operates, but, rather, the following two requirements: (i) holding an official authorization from the CVM and a certification from the certifying entity (Ancord)[60], and (ii) performing at least one of the advisory activities listed in the Securities Commission's regulation.

Regarding the first requirement, according to the Securities Commission's regulation (article 15 of Reg. 178), certification should be issued only to candidates who have concluded their upper secondary degree (thus, higher education is not required), passed on Ancord's exams of technical and ethics evaluation, and have a clean record, without prior conviction for financial crimes, fraudulent bankruptcy, among other infringements. These thresholds are not difficult to reach, as noticed by the number of new advisors per year in Brazil[61] and argued by a renowned investment advisor, to whom barriers to entry in the advisory profession are low[62].

Regarding the second requirement, the advisory activities are set in article 3 of Reg. 178, meaning advisors must perform at least one of these to be legally considered as such. The activities are the following:

"I – client prospection [for brokerage firms]

II – receiving, registering and transmitting transaction orders to the applicable trading and negotiation systems, in accordance with the pertaining rules;

III – providing information about offered investment products and services provided by the investment firm to which the advisor is related."

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59 Article 1 of Regulation CMN nº 2.838/01, as amended by Regulation CMN nº 4.982/2022.

60 Requirement based on articles 11 to 14 of Reg. 178, article 16, sole paragraph, of federal law nº 6.385/1976, and article 2, subsections I and II, of Reg. 2.838/2001.

61 *E.g.*, in 2022, the number of new advisors certified by Ancord (2023, p. 20) was 6.391.

62 Interview provided by a founder and partner of a major advisory firm in Brazil to Favoretto Rocha (2022).

In other words, advisors are agents of brokers in the securities market, prospecting and advising clients (investors) for brokers[63]. As allured in a previous occasion, while a bookseller advises his client throughout the shelves of a bookstore, the investment advisor advises the investor about the products in the market (Favoretto Rocha, 2021). While the bookseller is not entitled to the bookstore's client, the advisor is not entitled to the broker's client, since the advisor only acts on behalf of the broker.

To have a better practical idea of advisors' activities in Brazil, one of the major Brazilian brokers describe their advisors' activities as "presenting the most efficient ways of taking care of investor money, guiding individuals and legal entities through the universe of good investments according to the client's own profile"[64].

Therefore, advisors are among the many service providers to investors who operate in Brazil's securities market, alongside consultants, securities analysts and asset managers, for example, whose roles cannot be concomitantly performed by advisors due to explicit regulatory prohibition (article 7, § 1, of Reg. 178). In other words, advisors can only operate as advisors. Intermediary service providers may "advise" investors in a broad sense of the term, but, technically, only advisors perform the role defined as advisory in the regulation, as detailed above.

The more intellectual or, if you may, less operational work of advisors – thus, the one that has greater potential of influencing investors' decisions – is described in subsection III of the article transcribed above, under the term "provide information", since, according to § 2 of the same article, such role of providing information includes the "support, orientation, and investment recommendations inherent to the commercial relationship with the client". This is where the more tenuous biased advisory can occasionally come up.

In the 2023 regulatory reform propelled by the CVM, a relevant clarification was brought by Reg. 178, which not only added the "investment recommendations" in the realm of advisor's activities (thus, turning regulation closer to how

63 The role of agents performed by advisors is mainly drawn by the use of the term "*preposto*" (Portuguese legal term equivalent to agent) in the many regulations that refer to advisors.

64 This excerpt refers both to (independent) investment advisors and internal advisors hired by the broker. Excerpt available in <https://www.xpi.com.br/assessoria-xp/> Access on: 24/04/2023.

advisors truly operate[65]), but, also, added that "advisors must make sure that their own recommendations are compatible with the related broker's policies, rules, and procedures regarding client suitability" (article 3, § 2, of Reg. 178).

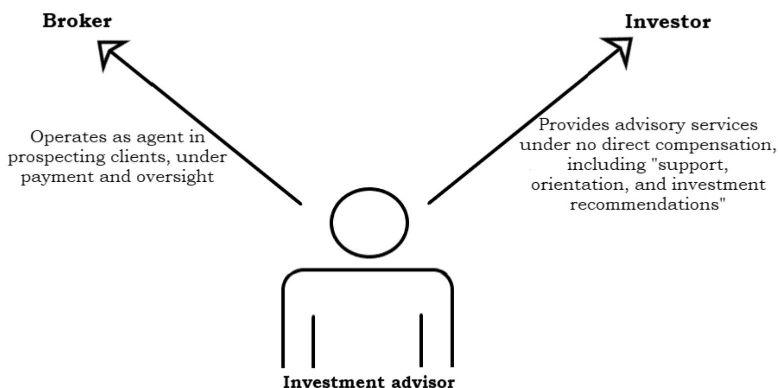
Being more precise in the description of advisory activities and naming these professionals as advisors, not as "autonomous investment agents", were positive changes promoted by the 2023 regulatory reform, since the advisory role performed by these agents became explicit in the rule. In other words, the gap between the law in the books and the law in action was narrowed by the Brazilian Securities Commission through Reg. 178.

To operate in the market, advisors must be related to at least one broker, either as an individual or as an associate to an advisory firm, pursuant to article 4 of Reg. 178. Brazilian regulation provides oversight duties for brokers over advisors, putting brokers in the position of gatekeepers. The mandatory attachment between brokers and advisors sets the framework for the supply chain of investment products because it is due to this requirement that advisors operate both for brokers and investors, meaning advisors only exist while they serve two distinct parties.

Thus, by exercising different roles, advisors serve two kings in the securities market. The main difference between the advisor's role towards these two parties can be summarized in, on one hand, acting as agent on behalf of brokers to prospect clients and diffuse brokerage services, under brokers' oversight and payment, while, on the other hand, advising investors and forwarding their investment orders, as illustrated in image 1 through a triangular perspective.

[65] According to experts in this market, advisors perform more than a purely operational role, such as forwarding investors' orders to trading systems. According to these interviews provided to Favoretto Rocha (2022), clients themselves demand their advisors to help them choose the adequate product and, in case of high-income investors, cooperate in structuring complex transactions.

**Image 1 – Triangular relation between the investment advisor and its hiring parties**




Source: Author's creation

The assertion that investment advisors serve two kings is, first and foremost, an assertion of fact. Given that advisors provide services of "support, orientation, and investment recommendations" to investors, they effectively interact between themselves. On the other hand, brokers hire advisors as agents under payment. An occasional conflict of interests over the advisor would be sufficiently problematic in this scenario, where the advisor interacts with both parties and can potentially affect them through these interactions.

However, an existing debate in Brazil is whether investors and advisors have a legal relationship between them – *i.e.*, a relationship that is recognised under the law. The question seems pointless when one understands that an advisor interacts with an investor, but the lack of a formal written agreement between them can occasionally raise this question. Moreover, the fact that the regulatory framework designed the advisor to be a mere agent of the broker can induce one to consider advisors as linked exclusively to brokers and no one else.

However, defining whether there is a legal bond between advisors and investments is legally crucial, since defining it as a bond of legal nature turns biased advisory into not only a problem of fact, but, also, a legal concern. In other words, this question can determine which remedies are available for investors when using advisory services, a topic further explored in chapter IV.

The Securities Commission's rules have always qualified advisors as a *longa manus* – *i.e.*, an extension – of brokers, since they have always occupied the position of brokers' agent (or "*preposto*", as technically named in Portuguese). This means advisors have always existed to act on behalf of third parties (brokers), not of themselves (CVM, 2020, p. 9).

Despite the option to design advisory services like this, the CVM's regulation requires that the advisor acts with "integrity, good faith and professional ethics" towards the investor, pursuant to article 23 of Reg. 178, as mentioned in chapter I. This duty shows that, even without a formal written agreement, advisors have legal duties toward the investor, meaning their relationship has legal effects.

Furthermore, the Securities Commission's rules extend to advisors the duties applicable to brokers[66]. Brokers' duties are stricter and go beyond a requirement of "integrity, good faith and professional ethics", given that they also encompass (i) a duty to "act on good faith, diligence and loyalty towards their clients" (article 31 of Resolution CVM nº 35/2021) and (ii) an explicit prohibition to "favour its own interests or those of related persons in detriment of clients' interests" (article 31, § 1st, of Resolution CVM nº 35/2021).

By extending duties of brokers to advisors, the Brazilian regulation requires advisors to be "loyal" to investors and prohibit advisors from favouring their own interests or those of related persons (*e.g.*, the broker) in detriment of the investor. Undoubtedly, a case of biased advisory would violate the advisor's legal duties toward the investor.

These duties lead to the conclusion that advisors serve two kings under a legal perspective as well. Serving the demand of more than one group does not necessarily generate conflict of interests. The current digital economy provides tons of examples of multisided platforms that attend to different demands. It all depends on the incentives to favour each side and the duties applicable to the agent in the middle.

The incentives and duties applied to advisors in Brazil will be explored later in this book, but, for now, theoretical perspectives can help one understand the role of advisors. This book uses two known theories to illustrate the investor's concern toward biased advisory services: the agency theory and the theory of transaction costs. These theories are applicable depending on one's

66 Currently, this extension can be interpreted from article 35, subsection II, of Reg. 178. However, before Reg. 178, the extension of brokers' duties to advisors was more explicit, as article 17 of Regulation nº 16/2021 explicitly asserted such extension, but no equivalent text was included in the Reg. 178 by the Securities Commission in the 2023 reform.

perspective of the investor-advisor relation: it can be seen as a relation between a principal and an agent (thus, applying the agency theory) or between two parties of a market transaction (thus, applying the theory of transaction costs).

As for the first perspective, the investor delegates some activities to the advisor, such as the role of evaluating investment products that fit the investor's profile and best interest[67]. Although the advisor's role was initially conceived as that of an agent to the brokerage firm and the advisor is prohibited from acting on behalf of the client, the advisory role includes activities delegated by the investor.

As for the second perspective, an advisor's conflict of interests is a problem to the investor even if no delegation takes place. The theory of transaction costs, which explains the costs incurred by market players to transact out of a firm structure (Krugman & Wells, 2015, p. 612), demonstrates that advisors' conflict of interests can also be a transaction cost to investors.

Choosing the most adequate theory to analyze the relation between investors and advisors is not an easy task, considering that, on one hand, the lack of explicit delegation by the investor to the advisor raises question about the agency nature of their relation and, on the other hand, the fact that advisors only act on behalf of brokers and the common lack of explicit contracting (*i.e.*, of a formal written agreement) between the advisor and the client raise question about the transactional nature of their relation. However, the investor-advisor relation can be alternatively framed under both perspectives, thus admitting the use of agency costs and transaction costs as lens to this issue.

One can argue that there is an agency relation between the advisor and the investor, where, in some circumstances, the advisor operates as an agent to the investor (principal) (Sitkoff, 2014, p. 48). In an agency relationship, a party (principal) delegates a task to another party (agent), who acts on behalf of the principal with some level of decision-making autonomy[68]. In turn, agency

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[67] About this theory, see Schneider (1987) and Jensen and Meckling (1976).

[68] Jensen and Meckling (1976, p. 308): "We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent."

costs are the costs incurred by the principal in monitoring the agent and the losses resulting from agent decisions that failed to maximize the principal's wellbeing (Jensen & Meckling, 1976, p. 308)[69].

The agency theory attributes these costs to the misalignment of interests between the agent and the principal, being the reason why this theory attempts to find the most adequate form of interaction between those two parties (Eisenhardt, 1989, p. 58). Although agency theory has been widely used to study corporate governance and the relation between managers and shareholders, it has also been used to study investment advisory services, as detailed below.

Just like any person, the investor has limited resources (*e.g.*, time and knowledge) to perform every role necessary to attend to his/her personal demands. In other words, regardless of how proactive and gifted you are, you will hardly have the time, knowledge, and tools to be your own doctor, lawyer, cook, plant your own food, build your own house from scratch and perform other roles you will demand throughout your lifetime.

This is why delegating some activities to third parties – *i.e.*, letting others act on your behalf or yourself act according to someone else's standard – is natural and economically rational. Every decision involves a trade-off: by going to the supermarket or spending time in social media, for example, one renounces the possibility of spending that time and resource in something else. Given that one does not live forever, time and other resources are valuable. Thus, sharing tasks is intrinsic to life in society (Schneider, 1987, p. 481).

This same rationale applies to the investor. Especially considering the complexity of the securities market, delegating some activities can be efficient and beneficial to investor interests (Chalmers & Reuter, 2012, p. 1). The role of operating your own investment account can be decomposed into more specific acts, encompassing the identification of your individual investment approach (risk profiling), search and evaluation of suitable investment products, and the practical execution of the transaction in an investment platform.

This rationale helps to explain why using advisory services can be rational for investors. Although advisors are legally prohibited to act on behalf of clients before market intermediaries[70], their role involves labelling the client according to a risk profile analysis, recommending products based on research and

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69 Although some consider paradoxid to name the principal's challenges as "costs" (Schneider, 1987), given that costs are measurable and these challenges are unpredictable, they are generally referred to as costs.

70 Article 25, II, of Regulation CVM nº 178/2023.

suitability analysis, and helping the client execute its own transactions. Even if the delegation is not explicit because there is no written agreement between the advisor and the investor, the nature of their relationship and the level of influence of advisor recommendations over investment decisions reveal a delegation. The decision to delegate can vary according to the investor, because proactive and self-sufficient investors tend to avoid delegation, but the complexity of the market and the advisor's expertise can justify a decision to hire these services.

Besides the possible rationale in delegating tasks, the advisor, like agents, has to attend to the client's interests, as explained above. The purpose of advisory services and the reference to fiduciary duties in contracts between brokers and advisors serve as additional evidence in this regard[71]. Therefore, the investor/advisor interaction has similar traits to that provided by the agency theory, making it a pertinent lens to approach the concern of biased advisory. Others also share the view that the Brazilian regulation provides fiduciary duties to the advisor[72].

Alternatively, the investor-advisor relation can also be studied under the perspective of transaction costs. Regardless of whether there is any real delegation from the investor to the advisor and despite the fact that brokers hire advisors as their *longa manus*, fact is that the investor uses the advisor's services. In economic terms, the encounter between these two players configures a transaction: the advisor provides services because the investor decided to use them and indirectly pays for them, as detailed in section III.2 below.

The theory of transaction costs is commonly used to explain the challenges in forming and executing an agreement between market players – *i.e.*, to operate with parties that do not belong to the corporate structure of the same firm,

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71 *E.g.*, agreement between *Walpires* and *Soldi Agentes Autônomos de Investimentos*, clause 4.1, (k).

72 In an interview provided to Favoretto Rocha (2022), Mr. Henrique Machado stated that the Brazilian regulation sets advisor's fiduciary duties toward investors. Additionally, he explained why advisors may be occasionally more interesting for a client than other service providers, indicating that advisors provide useful assistance in operational stages of an investment transaction. As indicated previously, Mr. Henrique is former commissioner of the Brazilian Securities Commission, attorney under the Brazilian Bar Association, former attorney-general of the Brazilian Central Bank, former Deputy Executive Secretary of the Brazilian Central Bank, former Secretary of the National Monetary Council, former Chief Advisor of the Subprosecutor-General of the Republic, and currently an investor.

implicating negotiation costs and unpredictability when signing a contract[73] –, which would be of little use to the investor-advisor relation because the contractual terms of the advisory services are set by the broker – as mentioned, investors and advisors often relate to one another without any formal written agreement.

However, this theory also seeks to reduce other costs, such as information asymmetry between two parties during a transaction (Sun *et al.*, 2020), to maximize wellbeing of the parties involved in a market transaction[74], meaning transaction costs may exist even when the two parties had not executed a formal written contract.

In summary, costs incurred by investors when using advisory services can be interpreted under different perspectives (either as agency costs or as transaction costs), depending on the theory that one wishes to adopt. In terms of conflict of interests, the burden of these costs can only be understood based on the risk of such conflict and the investor's capacity to address this risk, which will be explored below.

## 2. Hiring and payment conditions of investment advisors

As explained in the previous section, advisors are paid by brokers, although they possess a duty of loyalty and good faith towards investors and their advisory services are destined to investors, not only to brokers. Given that remuneration is a decisive incentive for a typically rational market player, studying the payment criteria is relevant to identify biased advisory when the player serves two kings.

In the Securities Commission's call for the 2019 public hearing regarding the regulatory reform of advisory rules, the Commission raised concerns about market practices related to advisors' compensation conditions, indicating that the advisor "has incentives to sell financial products that generate higher commission fees (or "rebates") and interest that the client executes as more transactions as possible, generating brokerage fees, which might not always be in the client's best interest" (CVM, 2019b, p. 14).

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73 The concept of transaction costs related to the moment of the formation of the contract is used, for example, by Scott and Triantis (2006, p. 823), who referred to the costs during the contract's execution as "enforcement costs" or "back-end costs".

74 Sun (*et al.*, 2020): "*The core concept of transaction cost theory aims to enhance economic efficiency within the process of product or service exchange through the market.*"

Despite this common knowledge, little is known about the exact conditions of investment advisors' compensation conditions, such as how exactly does their compensation vary in comparison to specific investment products or to the client's account turnover – *i.e.*, higher fees when the client buys and sells more investment products.

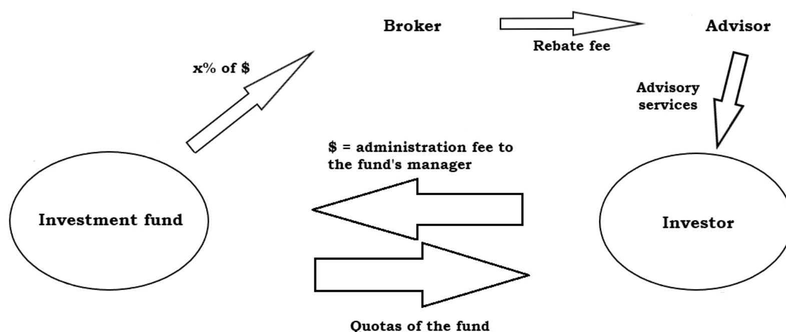
Based on information from the general press, it is known that there are two main models of compensating advisors for their services in Brazil: (i) variable-commission-based compensation (or rebate fee) and (ii) fixed rate compensation. In both models, the advisor's compensation is directly proportional to the client's invested amount – *i.e.*, the advisor gains more when the client invests more money –, but their difference is whether the rate over which the compensation is calculated varies according to the transacted product (*i.e.*, variable-commission-based compensation) or the rate is the same for all investment products (*i.e.*, fixed rate compensation).

As for the first model, advisors are, generally, paid through commissions called rebate fees. This commission is composed of two elements: a rate and a basis of calculation. Put simply, the rate is what multiplies the value that serves as basis – *e.g.*, if the rate is 10% and the basis is $ 100, the commission equates to $10.

Technically, the rebate fee is a portion of the brokerage fee that the investor pays to the broker, which is based on the capital return of the client's investment. How much of the client's capital return that is "caught" by the broker – and, thus, the advisor inclusively – is what varies in the variable-commission-based compensation model (Oliveira, 2020; GWX, 2020). Sources are not clear as to the portion of the brokerage fee to which the advisor's rebate fee usually corresponds, but they suggest it is usually between 15% and 30% (Rohr, 2020).

When the sold product is an investment fund quota, the fund pays to the broker a percentage (usually around 0,2% and 3,0%) of the administration fee paid by the investor to the fund's manager (CADE, 2017, pp. 66-67). Afterwards, part of this percentage is forwarded from the broker to the advisor under the form of commission or the so-called rebate fee. Image 2 illustrates this form of compensation:

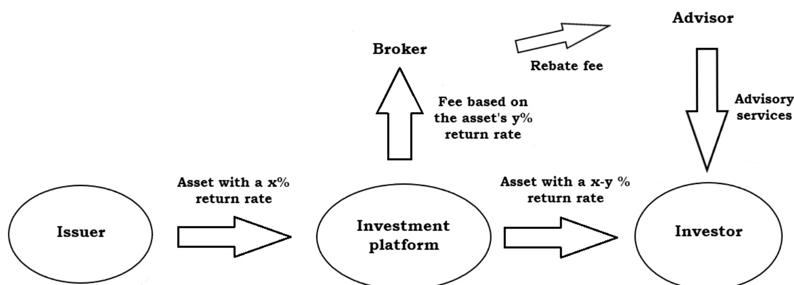
**Image 2 – Layout of the advisory fee through investment fund quotas**




Source: Author's creation

On the other hand, when the product is another security or a banking asset, the broker offers the product to the investor under a lower return rate than that initially set by the issuer, meaning the investor and the broker will share the product's capital return. In this case, the brokerage fee consists of the difference between the product's total return rate and the investor's own return rate (CADE, 2017, p. 67). Part of this brokerage fee is forwarded to advisors in the form of commission or rebate fees, as illustrated in image 3.

**Image 3 – Layout of the advisory fee through banking assets and securities**




Source: Author's creation

In summary, regardless of the various forms under which advisors may be paid and their fees may be calculated, the common trait of this compensation model is that the product can lead to different rates of commission. Put simply,

the investor's choice of which products to purchase is relevant for the advisor's compensation interest – how much is this relevant is something to be cleared in the following pages. The exact rate of each product is something clients do not usually know, since this information is commonly concealed in documents or online databases to which only brokers and advisors can access.

Regarding the second model (fixed rate compensation), in which the fee is based on a fixed rate, brokers and advisors tend to rarely adopt it in Brazil (Rohr, 2020), although it has been growing recently (Magnavita, 2023). In these cases of fixed rate compensation, the value of the fee is the multiplication of the invested amount by the set rate and the client is charged either monthly or on a single instalment when redemption takes place (Rohr, 2020) – *i.e.*, when the investor requests the payment of the earnings from the investment she/he had made.

To give a concrete example of this model, one of the biggest investment platforms in Brazil offer this model of advisory based on a rate between 0,6% and 1,0% per year over the client's annual investment amount, though charged monthly[75]. Another broker offers this model under a rate between 0,3% and 1,0% (Wiltgen, 2020).

Although this compensation model became more known and accessible after the recent general debate about rebate fees in Brazil, fixed rate compensation was already available to higher-income investors (Torres & Bertão, 2020b) and, though currently offered to all other retail investors, it is not the default option – *i.e.*, in case the client does not explicitly choose an advisory service based on the fixed compensation model, the applicable model is the rebate fee (GWX, 2020). In addition, even if the advisor's fee has a fix rate, the broker's fee can still vary per product (Seabra, 2023).

Having cleared how both models work, one should now investigate what are the conflicting incentives from these compensation conditions. Some argue that the mere variation of the fee's rate per investment product is sufficient to assert that the advisor is subject to conflict of interests[76]. However, knowing how this variation occurs is important, since the bigger the gap between each product's fee, the bigger the potential to conflict of interests.

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75 Rate published by XP *Investimentos* in: <https://lp.xpi.com.br/assessores-autonomos> Access on: 03/12/2023. When this firm began to offer the fixed fee model, the rate was between 0,5 and 1,0% of the client's yearly invested amount (Torres & Bertão, 2020a).

76 In this sense: <https://warren.com.br/blog/agente-autonomo-de-investimentos/> Access on: 20/07/2021.

To investigate it, this research resorted to an empirical analysis of documents executed by market players. Based on 87 judicial disputes between brokers and advisors, the author found 10 contracts that were available in the case records of eight proceedings[77]. The main aspects of these agreements, including the form or remuneration, the existence of goal-oriented standards, and the existence of clauses to address conflict of interests, are available in table 3.

**Table 3 – Overview of provisions related to payment conditions and conflict of interests in agreements between brokerage firms and investment advisors**

| **Parties** | | **Date of the agreement or its most recent amendment** | **Form of remuneration** | **Does it have goal-oriented standards?** | **Is there a duty or oversight mechanism that addresses conflict of interests?** |
|---|---|---|---|---|---|
| **Brokerage firm** | **Investment advisor** | | | | |
| *Banco BTG Pactual S.A.* | *Porte Agente Autônomo de Investimentos Ltda.* | 05-09-2019 | Product-based commission (variable fee) | Yes | Yes |
| | *Confiança Agente Autônomo de Investimentos Financeiros S/S Ltda.* | 20-10-2020 | Product-based commission (variable fee) | No | Yes |
| *Walpires S.A. Corretora de Câmbio, Títulos e Valores Mobiliários* | *Soldi Agentes Autônomos de Investimentos Ltda.* | 09-04-2012 | Same percentage for all products (fixed fee). Possibility of advisor compensation based on fines applied to the client's debt. | No | Yes |

77 For further information about the judicial proceedings where the agreements where found, please refer to footnote 31 in chapter II.

| | | | | | |
|---|---|---|---|---|---|
| XP *Investimentos Corretora de Câmbio, Títulos e Valores Mobiliários* S.A. | *Ação Investimentos – Agente Autônomo de Investimento Sociedade Simples* | Not available | Product-based commission (variable fee) | Yes | Yes |
| | *Acqua – Agente Autônomo de Investimentos Ltda.* | 02-10-2018 | Product-based commission (variable fee) | Yes | Yes |
| | CDR *Agentes Autônomos de Investimentos Ltda.* | 11-07-2018 | Product-based commission (variable fee) | Yes | Yes |
| | *Confiança Agente Autônomo de Investimentos Financeiros S/S Ltda.* | 07-01-2019 | Product-based commission (variable fee) | Yes | Yes |
| | *EuQueroInvestir Agentes Autônomos de Investimentos* S/S ("EQI") | 07-12-2018 | Product-based commission (variable fee) | Yes | Yes |
| | *Marcelo Galvão Morroni – Agente Autônomo de Investimento –* EPP | 23-12-2016 | Product-based commission (variable fee) | Yes | Yes |
| | *One Agentes Autônomos de Investimentos Ltda.* | 18-04-2016 | Product-based commission (variable fee) | Yes | Yes |

Source: Author's creation

The main takeaways of these agreements can be summarized in the three following bullet-points:

- All agreements have duties or oversight mechanisms that address, either directly or indirectly, the possibility of the hired advisor's conflict of interests.
- The compensation model adopted in all analysed agreements is the rebate fee (variable-commission-based compensation) and the biggest gap of rebate fees takes place when comparing quotas of different investment funds.
- Brokers commonly offer additional payments in case advisors reach certain goals, mainly concerning clients' investment amounts, as an incentive mechanism to guide advisors' performance.

Regarding the first finding, it is noticeable how all contracts, with no exceptions, have clauses that somehow address the hypothesis of biased advisory. For example, notwithstanding further in-depth analysis in chapter IV, such clauses include prohibitions of "practices that may violate the fiduciary relationship maintained with investors"[78] and obligations for advisors to submit clients to a prior investment profile verification, for suitability purposes[79].

The existence of such clauses in all agreements serves to understand whether current hiring conditions of investment advisors have the potential to generate conflict of interests. These clauses demonstrate that biased advisory is a prominent risk to these transactions and raises some level of concern to brokers – if it were not, high profile agreements such as these would hardly include clauses of this nature so frequently.

Some may argue that addressing conflict of interests in written contracts does not confirm its potential existence, since contracts, by definition, regulate unexpected issues as well – for example, force majeure and acts of God clauses commonly included in written agreements. However, conflict of interests is

[78] *E.g.*, agreement between *Walpires* and *Soldi Agentes Autônomos de Investimentos*, clause 4.1, (k); agreement between *XP Investimentos* and *CDR Agentes Autônomos de Investimentos*, clause 3.4.3, (b), which refers only to the fiduciary relation between the client and the brokerage firm.

[79] *E.g.*, agreement between *BTG Pactual* and *Porte Agente Autônomo de Investimento*, clause 2.4; agreement between *BTG Pactual* and *Confiança Agente Autônomo de Investimentos Financeiros S/S Ltda.*, clause 2.4.

not a recurrent issue only in contracts, but, also, in brokers' compliance policies, which are typically focused on issues of highest corporate concern, not just hypothetical ones[80].

Compliance policies of brokerage firms make explicit references to conflict of interests, such as *BTG Pactual*'s Guidelines of Procedures and Oversight for Investment Advisors ("*Manual de Procedimentos e Supervisão de AAI*")[81], which mentions that "real and potential conflict of interests are potential in integrated financial groups (...) BTG Pactual expects that the investment advisor identifies and avoids these conflicts of interests in an appropriate form, with absolute transparency".

*Órama* DTVM's Policy for Investment Advisors ("*Política para Agente Autônomo de Investimentos*")[82] provides broad oversight procedures, without explicit references to conflict of interests, but addressing it indirectly by stipulating that the broker's business development department has the role of "maintaining regular visits to the advisor and/or other forms of interaction that enable to confirm that the advisor continues to act with integrity, good faith and professional ethics towards clients and *Órama*".

Furthermore, the Policy of Ethic Principles and Rules of Conduct for Collaborators[83] ("*Política de princípios éticos, regras de conduta e de atuação dos colaboradores*") from the same brokerage firm provides as principle the "loyal provision of services to investors, avoiding practices that may harm the fiduciary relationship kept with them and adopting wide transparency in potential situations of conflict of interests".

Thus, these policy provisions along with the clauses found in the written agreements serve as, at least, an indication that investment advisory bears potential conflict of interests. Such document-based findings should not be disregarded.

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80 According to guidelines provided by international organisations like the OECD, the World Bank and the UNODC, corporate compliance programmes should be structured based on the mapping of internal risk and the identification of gaps of internal control mechanisms. Although these guidelines are commonly directed to anticorruption policies, their universal nature suggests that any corporate compliance programme is or should be structure according to the company's concerns and potential risks. In this sense, OECD, UNODC & World Bank (2013. pp. 10-13) and Viol (2021, pp. 177-178).

81 Available in <https://www.sejabtg.com/assets/files/Manual_do_AAI_site.pdf> Access on: 04/05/2023.

82 Available in <https://orama-media.s3.amazonaws.com/public_area_files/20210127_-_Agente_Autonomo_de_Investimentos_-_1.7.pdf> Access on: 08/03/2022.

83 Available in <https://orama-media.s3.amazonaws.com/public_area_files/Princípios_Éticos_Regras_de_Conduta_e_Atuação_dos_Colaboradores.pdf> Access on: 08/03/2022.

The second finding is that, despite having duties and oversight mechanisms to address conflict of interests, all of these agreements adopt rebate fees to compensate advisors for their services, with a remark on the wider gap between quotas of different investment funds. By reading these contracts, one notices that the rates and calculation criteria for advisors' commissions are usually detailed at the contract's appendix. There is no universal or standard rate in the market, as it can be noticed by the wide variety of rates adopted in these agreements.

For example, in the agreement executed between *XP Investimentos* and *Acqua Agente Autônomo de Investimentos*, the commission for securities traded at the BM&F segment of the stock exchange amounted to 77% of XP's brokerage fee (clause 1 of Annex 1 of the contract), while the commission for quotas of closed investment clubs amounted to 50% of XP's administration fee in each club (clause 7 of Annex 1 of the contract). In this same contract, there were investment funds which led to an advisory fee of 40% of the administration fee and 20% of the performance fee, while another fund led to an advisory fee of 18% of the administration fee and 15% of the performance fee (clause 6.6 of Annex 1 of the contract).

The other contracts and clauses of the sample present the same pattern of advisor compensation. In summary, there is a significant difference between the rates applicable to the pool of investment products available to clients. Even though the rate itself is not sufficient to determine the value of the advisory fee because it can vary according to the basis of calculation, the fact is that higher rates tend to lead to higher fees and, thus, higher incentives over the advisor.

Does the variation of rates mean that advisor compensation is purposefully structured to bypass investor suitability and generate conflicting interests? Not necessarily. Firstly, some investment products may be more complex to analyse (due to the economic sector to which they are related or their contractual conditions, for example), so the advisor's effort must be compensated by higher fees. Additionally, as once statement by partner of a major brokerage firm (Favoretto Rocha, 2022, p. 63), factors related to the product, such as risks, duration until capital return, and goal of compensating better investment fund managers, also justify the variation of fees among products.

Thus, these documents serve as a sufficient sample of empirical evidence that rebate fees are widely adopted in Brazil to compensate advisors, especially considering that most of the 10 agreements concern the biggest investment platforms in the country. Other than these agreements, additional evidence

is the standard agreement between *Grupo Bradesco*'s brokerage firm and its clients, where this same compensation model is mentioned as the applicable one to its advisors[84].

Finally, the third finding arising from these contracts is the goal-oriented standard used by brokers to shape advisors' incentives. Interestingly, although most business goal clauses concerned clients' investment amounts (thus, seeking higher investments), some contracts had clauses that enabled brokers to set goals concerning "revenue goals, asset prospection goals and transaction goals (quantitative and/or qualitative)"[85]. These clauses reveal wide discretion by brokers to shape advisor incentives and set goals according to specific products and transactions – note the "qualitative" reference in the transaction goals.

Still in this aspect, it is interesting that the agreements determine that, by reaching the set goals, advisors will gain either a higher rate to calculate his/her rebate fee – *e.g.*, an additional 0,8% rate to multiply the investment amount prospected by the advisor – or a fixed bonus – *e.g.*, an award of BRL 22.5 million, meaning over € 4.1 million[86]. In relation to some advisory firms, brokers use only one of these methods, while, in others, brokers include both methods of setting goals in their agreements[87]. Regardless of the method, one should notice that, although the goals are not mandatory – *i.e.*, advisors are not sanctioned for not achieving them –, they implicate great difference in advisors' overall compensation once they are reached.

The use of goal-oriented standards to shape the advisor's conduct is curious, since it provides a trait similar to bank managers, who knowingly have aggressive goals to attend to and, thus, are used in brokers' rhetoric to argue that advisors are more aligned with client interests than bank managers who have monthly goals of investment[88].

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84 Standard agreement of *Bradesco* S.A. *Corretora de Títulos e Valores Mobiliários*, of January 2019, clause 10.3.

85 *E.g.*, agreement between XP *Investimentos* and *One Agentes Autônomos de Investimentos Ltda.*, clause 5.4, item (ii).

86 Currency conversion made in 30/11/2023, based on the Brazilian Central Bank's official calculator, wherein one Brazilian Real amounted to 0,1861712 euro.

87 The method of an additional rate is present in the agreement between XP *Investimentos* and *Acqua Agente Autônomo de Investimentos* (clauses 12 and 13 of Annex 1). The method of granting a fixed valued award is present in the agreement between XP *Investimentos* and *EuQueroInvestir* (EQI) (clause 12 of Annex 1). The possibility of both method is provided, *e.g.*, by the agreement between XP *Investimentos* and *One Agentes Autônomos de Investimentos Ltda.* (clause 5.4).

88 XP *Investimentos*' manifestation to the CVM's Public Hearing SDM nº 03/2019 (p. 8).

The effects of goal-oriented standards over advisors' conducts can be many. In regard to conflict of interests, the pertinent question is whether goals that lead to substantial leverage of remuneration can strongly shape the advisory service towards achieving those goals, shadowing the incentives to attend to a tailored suitability – in other words, if attractive advisory goals generate interests that conflict with the client's interests.

Setting goals tends to have such impact when the goals are directed toward specific products (asymmetric goals) or high account turnover, not to the overall invested amount regardless of the products acquired by the investor or to the account's turnover. Both types of goals are, at least legally, admitted in the agreements executed between brokers and advisors in Brazil. Considering that the analysed contracts enable revenue and transaction goals, on a quantitative and qualitative basis, asymmetric goals and turnover goals are possible and contractually admitted – whether they are indeed common has not been possible to assert, given that access to brokers' daily online systems would be required. How much can asymmetric goals be compatible to clients' interests is explored in the following subsection.

## 3. Conflict of interests in investment advisory services

While the previous section described how brokers and advisors operate in terms of hiring and compensation conditions, we now focus on these practices' risk of generating conflict of interests. Given this book's legal approach, we first have to define the concept of conflict of interests or biased advisory under Brazilian law before qualifying the expected effects of the market practices analysed above.

There is no explicit or consolidated definition of conflict of interests in laws that concern investment advisory in Brazil. Assuming that the law is a coherent system that demands a systematic interpretation (at least in theory), Brazil's Corporation Act (federal law nº 6.604/1976) can be used as a standard. This law references conflict of interests in relation to three situations: the fiduciary agent towards the debenture bond holder[89], the use of voting rights by shareholders[90], and the performance of company managers[91].

None of these articles provide a clear and specific legal definition of conflict of interests. Even though, by the context of the situations they refer to, one must deduce that conflict of interests demands two elements: (i) an alignment

[89] Article 66, § 3, of federal law nº 6.404/1976.

[90] Article 115 of federal law nº 6.404/1976.

[91] Article 156 of federal law nº 6.404/1976.

of interests between at least two parties (or, at least, a presumption thereof) and (ii) an incentive or act that breaches their bond of trust or contradicts the role previously granted to the conflicted agent – *i.e.*, the fiduciary agent towards the debenture bond holder, the shareholder towards the company, and the manager towards the company. In all of these three situations, there was an alignment of interests between the parties before the conflict.

Going a little beyond corporate law, federal law nº 12.813/2013 addresses conflict of interests of persons who act on behalf of Brazil's federal Administration. Every situation of conflict of interests listed in this norm refers to cases where an agent has incentives to favour personal interests in detriment of the interest that he/she should defend – *i.e.*, public interest[92]. In these cases, although there is no direct and individual relationship between the conflicted agent (in a sense, a trustee of public faith) and the owner of the harmed interest (society in general), there is still a breach of the bond of trust that linked both together, namely, the oath sworn by the federal servant when entering the position.

Given the above, there are sufficient elements to assert that the Brazilian legislator adopted the following concept of conflict of interests: a conflict that takes place in situations where there is a breach of a bond of trust or a misalignment of interests between an agent and the person or entity whose interest he/she should favour.

This concept fits the perspectives used in previous academic works concerning investment advisory services. Conflict of interests should not be misunderstood as a mere divergence of interests between two parties of a transaction – for example, a buyer who is interested in buying under low prices and a seller who is interested in selling under high prices. Differently, conflict of interests assumes that there must be a subservience of interests from one party to another (Nelson, 2008, p. 146). In other words, one party legitimately expects that the other party seeks to attend to the former's interests.

This subservience assumption exists in the investor-advisor relationship – naturally, when it comes to acts under the scope of advisory services –, considering that the advisor has the duty to act with "all the caution and diligence expected from a professional in their position" (article 24 of Reg. 178), while the demand for advisory services is underlined in the client's best interests. Moreover, the prevalence of investor interests is explicitly determined by the regulatory framework, which, as seen above, extends brokers' duties to advisors, including the duty of loyalty to the client and the prohibition from favouring any interest in detriment of the client. Therefore, the first element of the con-

92 Article 5 of federal law nº 12.813/2013.

cept of conflict of interests (subservience assumption that constitutes a bond or alignment of interests between the parties) exists in the investor-advisor relation.

Studies worldwide have shown that advisory services are commonly used by, in particular, high-income investors, who tend to resort to expert advice to base their investment decisions, even if only as a complementary opinion to have as additional guidance[93]. Furthermore, investors in general hardly search for investment products on their own initiative[94], meaning advisory services fulfil a strong role of guidance to investment decisions.

Expert interviews confirm that this pattern also takes place in Brazil, where advisors have strong influence over clients' decisions and clients hardly question their advisors' recommendations[95]. Different survey reports issued by Anbima (2021, p. 20; 2023, p. 19) demonstrate that the biggest source of information for Brazilian investors to make decisions is their account manager or investment advisor, most of which prefer in-person conversations with these agents. Despite this influence, investors rarely suspect or reflex upon their advisors' recommendations[96].

This leniency of clients to advisors reinforces the existence of a bond of trust between both parties. Furthermore, this leniency is, in a sense, natural and intrinsic to advisory services. After all, if the client did not need the advisor's expertise, he/she would not have hired it in the first place. However, just like each patient has an individual approach when going to a doctor's appointment, each investor can have an individual approach when interacting with advisors. More than that, given the potential impact of advice in investment decisions,

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93 Ottavianni and Inderst (2012, p. 497): "*Several studies have shown that investors with more education and higher financial literacy are more likely to seek (additional) financial advice (Hackethal, Haliassos, and Jappelli 2012; van Rooij, Lusardi, and Alessie 2011)*"

94 Ottavianni and Inderst (2012, p. 497): "*In spite of the range of options, consumers appear to search very little before choosing a product, possibly because they are overwhelmed by the complexity.*"

95 According to an interview provided by Joaquim Paiffer, investor and founding partner of asset management firm Atompar, and a founding partner of a major advisory firm, investment advisors play a highly influential role in investor decisions, especially in the case of unexperienced investors (Favoretto Rocha, 2022, p. 68).

96 Ottaviani and Inderst (2012, p. 500): "*We initially consider the benchmark case in which all consumers are wary, even though this case may not always be particularly realistic in markets for retail financial services given the evidence that many consumers credulously trust advisers or are naively inattentive to the influence of commissions.*"

investors should have a proactive position, regardless of lack of expertise, in order to take questions out of the way, assure clear comprehension and avoid biased advisory.

The second element of the concept of conflict of interests can also be found in the investor-advisor relation – *i.e.*, an incentive or act that breaches their bond of trust or contradicts the advisor's role. Other academic works have explored conflict of interests in advisory services, commonly attributing it to the advisor's compensation conditions. Anagol, Cole and Sarkar (2016) conducted empirical research about the behaviour of life insurance agents in India, encompassing the effects of commission-based compensation in their advisory services to clients. In this study, the authors found that the variation of agents' recommendations varied beyond clients' profile variation, meaning client suitability was not the only factor to influence life insurance agents' recommendations (Anagol *et al.*, 2016, p. 3).

In another empirical work concerning investment advisors (Foerster *et al.*, 2017, p. 1443), based on a survey of data provided by four major Canadian financial institutions, the authors divided clients based on personal characteristics (age, income, risk aversion, among others) and compared each group's investment portfolio, finding that no real coherence existed between the portfolios and the clients' profiles. This led to the study's conclusion that client suitability was not used – at least, not exclusively – to base advisors' recommendations for clients.

Furthermore, when comparing advisors' (not clients') characteristics with the recommended portfolios, the authors found greater coherence in percentage terms, meaning the advisor's characteristics tend to be more influencing to shape advisory than the client's characteristics. In other words, advisors tend to formulate their advices to clients under a uniform approach, what the authors described as the "advisor effect" over investors[97].

[97] The authors considered the possibility of similar portfolios due to different clients seeking a particular type of advisor (in other words, uniform recommendations would be aligned with clients' interests). However, when analysing clients who switch to an alternative advisor due to the previous advisor's death, retirement or departure, the authors found that clients used to seek advisors with different characteristics. "One interpretation of this finding is that, instead of customizing, advisors build very similar portfolios for many of their clients. Another interpretation is that matching between investors and advisors leads to common variation in portfolio allocations among investors of the same advisor, that is, advisor fixed effects capture omitted client characteristics that are common across investors of the same advisor. (…) We conclude that the advisor effects in our baseline model are not merely an artifact of omitted preferences common among clients of the same advisor." (Foerster *et al.*, 2017, pp. 1443-1444)

As these studies demonstrate, investigating advisor incentives is not a unique concern to Brazil. Conflict of interests in advisory services is subject to attention internationally for years and has already been approached as an occasionally inevitable issue. In 1990, the International Organization of Securities Commissions (IOSCO) issued a report of international conduct of business principles destined to intermediary service providers. Among these principles, one states that "a firm should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its customers are fairly treated"[98].

The Australian securities commission provided additional insights about conflict of interests in the financial services industry in general by suggesting solutions to hypothetical case-problems (ASIC, 2006). While approaching examples related to retail advisory services, the Australian authority showed that conflict of interests usually arise from the advisor's compensation conditions, specifically when (i) the compensation is predominantly or entirely variable-based and proportionate to the client's account turnover, in a way that the advisor has incentives to recommend the sale or acquisition of a product even when keeping the investment account intact is more beneficial and suitable to the client, (ii) the advisor or the broker to which the advisor is related have any form of bond with an issuer, in a way that the advisor is biased towards investment products of specific issuers, and (iii) the advisor receives differentiated compensation according to specific products, regardless of any bond with issuers (ASIC, 2006, pp. 9-14).

In summary, previous works have already explored the topic of conflict of interests in investment advisory services in other jurisdictions, arguing that conflict of interests is a potential issue and that among the main driving elements of advisor incentives are the compensation conditions and the advisor's own personal perspectives about the market. The existence of conflicting incentives (second element of the concept of conflict of interests) is, therefore, present.

The risk of conflicting incentives could come from both the advisors' variable-based commission and attractive goals, both empirical findings from section III.2. Regarding the variable-based commission, its effects can be better understood from, once again, comparing advisory services to a buyer-seller interaction. When you walk into a store, you know the seller might be interested in selling as much products as possible (or the most expensive ones) if the seller is paid on commission. However, the investor's position is far more vulnerable.

98 Available in <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD8.pdf>

While retail sellers are usually paid on commission based on the overall amount of sales, advisors' commission may be based on specific products, which the investor, as a buyer, does not know. While buyers have a reasonably clear picture of the products available in the store, investors do not have as bright a picture of the complex securities market. While buyers have a clear understanding of the cost (price) to which they are incurring when buying a product in the store, investors have a harder effort to estimate their own costs because it depends on risk analysis and estimated capital return. In addition, the differences of commission rates among investment products are not neglectable, as shown by the agreements in the previous section.

Regarding the effects of attractive advisory goals, goal-oriented standards are not necessarily incompatible to each client's interests. If the client's interest is positioned at the highest level of priority, the goal can be achieved, as long as the client's interest does not conflict with the goal. This type of assertion should be done on a case-by-case basis. For example, assume that two new products were issued in the market (product A and product B) and the advisor received a goal to distribute product B. When attending the client and noticing product A is more suitable to the client's individual profile, the advisor refrains from recommending product B and does not achieve the goal set by the broker. On the other hand, if both products were equally compatible to the client's individual profile, recommending product B would allow the advisor to attend to both investor suitability and the broker's goal.

However, studies in the field of behavioural economics indicate that the mere existence of goals is sufficient to change the goal recipient's behaviour, depending on the context. For example, Cryder, Loewenstein and Seltman (2013) demonstrated that the imminence of reaching a goal turns that goal more attractive and, thus, more influential as a driving factor to human behaviour. This conclusion was reached by the authors after controlled empirical studies, where they verified that crowdfunding projects received more donations when their goals were closer to being reached.

In another study, where the focus was the impact of individual wellbeing on incentives to achieve goals, Kivetz, Urminsky and Zheng (2006) also showed that the proximity to reach a goal enhances its attractivity, such as the client who increases expenses to obtain coupons when he or she is close to reaching the necessary number of coupons to get discounts or a free additional product.

This effect of enhancing the incentives to achieve a goal due to the proximity of it being reached is known as the "goal-gradient effect" and it can be applicable to investment advisory services to reflex upon the goal-oriented standards set by brokers. Based on this effect, these standards can influence advisors if

the goals are set at a reachable range. Using the hypothetical example above, if the advisor was close to reaching the goal of distributing product B, the risk of investor suitability being set aside to privilege the recommendation of product B would be higher. Naturally, if the award for achieving the goal is high – as the ones seen in section III.2 –, the incentives to operate according to its standard are even higher.

Besides variable-based commissions and goal-oriented standards, the burden of costs borne by a professional can also serve as an incentive to favour his own interests in detriment of the client's. In the case of investment advisors, the deductions that take place between the definition of the rebate fee and the effective transfer of the fee to the individual advisor are costs that can shape incentives.

The deductions are summarized in table 4, encompassing tax deductions, an administrative regulatory charge (supervisory fee), and the amount kept by the advisory firm, in the case of associated advisors.

**Table 4 – Costs for investment advisors**

| Cost | Value |
|---|---|
| Supervisory fee (anually charged by the CVM) | BRL 530.00 (individual) BRL 2.538.50 (firm) |
| Tax over services (ISS) (charged per transaction) | Varies per municipality (*e.g.*, 5% over the service fees in the State of São Paulo) |
| Tax over income (IR) (charged per fiscal year) | Varies per range of income |
| PIS (monthly charged over revenue) | Variável por regime de apuração (generally, a rate of 1,65%) |
| COFINS (monthly charged over revenue) | Variável por regime de apuração (generally, a rate of 7,6%) |
| Retention by the firm to which the advisor is associated. | Varies according to each firm's policy (the deductions can vary between 30% and 70%) |

The supervisory fee has been a major issue in Brazil, in the late 2010s and early 2020s. This is a mandatory fee charged by the Securities Commission from regulated players, including advisors, as part of the obligations resulting from the authorization issued by the authority and a form of compensating pub-

lic funds for the regulatory role performed by the CVM. Many argued that the supervisory fee was overly burdensome to individual advisors and small firms alike, since it is a fixed value that is not based proportionately on the advisor's income.

Before a federal law enacted in 2022 (law nº 14.317/2022), which set the fee on an annual basis and reduced its value, the amount applicable to individual advisors was BRL 634,63 per trimester – nearly € 115,00[99] – and the amount applicable to advisory firms was BRL 1.269,25 per trimester – nearly € 230,00[100]. This meant that, just to operate regularly, an advisor had to pay BRL 2.538,52 each year – nearly € 460,00[101] –, while a firm had to pay BRL 5.077,00 annually – nearly € 920,00[102] –, having these amounts been reduced to BRL 530,00 and BRL 2.538,50, respectively, in 2022.

Naturally, defining whether a price or a charged value is burdensome depends on the payer's buy power. To have a better picture of the impact of the fee over advisors, let's explore an example. Consider a rebate fee of 50% over a broker fee of BRL 5,00, an average amount charged by brokers[103]. In this case, an advisor would need to intermediate over 1.015 transactions per year just to raise the amount to pay the Securities Commission's supervisory fee, revealing that such advisor is encouraged to influence clients toward many transactions (high investment account turnover), prioritize high-income clients, and favour products that lead to higher fees.

However, this adverse effect of advisors' costs is a plausible effect for advisors that operate on a standalone basis or in small firms. In previous interviews conducted by the author, an advisor associated to a small-sized firm argued that the costs are burdensome, put advisors in a weak position of the supply chain of investment products and favour an environment where only big advisory firms prevail. Meanwhile, the founding partner of a major investment advisory firm argued that the costs are natural to any profession in the securities market and nearly irrelevant to shape individual incentives. Regardless of what

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99 Currency conversion made in 29/04/2023, based on the Brazilian Central Bank's calculator, wherein one Brazilian Real amounted to 0,1811332 euro.

100 Currency conversion as described in the above footnote.

101 Currency conversion as described in the above footnote.

102 Currency conversion as described in the above footnote.

103 Average value found in research available in: <https://www.spacemoney.com.br/spacedicas/taxa-de-corretagem-o-que-e-e-quanto-cada-corretora-cobra/163830/> Access on: 05/10/2021.

market players are most affected by fixed costs, these are hardly the main driving incentive of advisory services and its impact on advisors was minimized by the 2022 amendment[104].

As the reflections above fit into the concept of conflict of interests, one should note that the sources of risk of biased advisory (the "black holes" of the advisory profession) can vary from each player's context, such as the goal-oriented standards for large advisory firms or the fixed costs for small firms. Beside these peculiarities, the structure of rebate fees, as previously explained, can be a common black hole.

Anyhow, the main lesson is that potential conflict of interests is not the result of a unique and isolated factor, but, rather, a multifactorial risk of current market practices. Factors that can jointly contribute to a biased advisory service are (i) compensation conditions according to which the advisor's fee is higher based on specific investment products and/or on client's account turnover, (ii) use of reachable and attractive goal-oriented standards, (iii) poor transparency of the advisor's compensation conditions toward the investor, (iv) burdening fixed costs, and (v) lack of financial education by investors in general, weakening monitoring conditions.

Given these potential risks of conflict of interests between the advisor and the investor, agency and transaction costs tend to be significant. These costs are even higher when the client lacks expertise and, thus, the ideal conditions to monitor the advisor, which is the case of most investors in Brazil, where financial education is timid, as seen in the previous chapter.

Having identified the legal issue at hand, we now pass on to the legal tools that are available for investor protection in Brazil. Looking into the investor-advisor relation as a transaction or as a principal/agent relation, it is up to the law to reduce the investor's transaction or agency costs and promote a legal framework that favours efficiency. In different legal frameworks, despite the lack of direct references to conflict of interests, advisors are subject to different rules and investors have various protection tools, as explored in the next chapter.

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[104] It is worth noting that some legislative proposals currently undergoing in Brazil's House of Representatives intend to exempt advisors from paying the supervisory fee or implement an 85% discount in case of "manifest disproportionality". In this sense, bill nº 2.690/2021 and bill nº 2.631/2021.

# IV. Legal tools of investor protection

This chapter identifies what legal tools the Brazilian competition law regulatory and private law frameworks provide to protect retail investors against conflict of interests in advisory services and their gaps. In view of achieving this, the subsections below map each of these legal frameworks by describing the legal tools available for retail investors and their limits against conflict of interests.

The conflict of interests identified in the previous chapter can be legally addressed in different forms. In other words, shaping the law to address a market failure involves a policy decision. In Brazil, there are various legal frameworks applicable to investment advisors, who, as players of the securities market that operate under the principle of free enterprise, must comply with limits and standards set by the law, under supervision of law enforcement authorities[105] (Di Pietro, 2013, pp. 124-125).

This book focuses on competition law, regulatory and private law frameworks as the sources of legal tools of investor protection. Regarding the two latter, the regulatory framework is presented as encompassing a State-regulated set of rules and a market-regulated one, while the private law framework encompasses both contract law and tort/liability law.

The use of an interdisciplinary approach is not a novelty in academic scholarship, as past works that analysed various legal regimes simultaneously demonstrate[106]. Although interdisciplinary approaches to legal issues are not new in academic research, its use to analyse conflict of interests in investment advisory is a novelty[107].

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105 Though exceptional in legal terms, the limitation of securities market players' freedom of enterprise according to public interest is based on article 170, sole paragraph, of Brazil's 1988 Federal Constitution and article 16, III, of federal law nº 6.385/1976.

106 To illustrate, Pereira Neto and Jones (2021) approached the systemic corruption schemes revealed by Car Wash Operation under different perspectives, revealing the multiplicity of norms and institutions that addressed these facts in Brazil. Machado and Ferreira (2014) also adopted various legal regimes for a case study concerning a corruption scandal involving the 1992 public procurement for the construction of São Paulo's Regional Labour Court. In studies related to the securities market, this kind of approach has also been used. Prado, Rachman and Vilela (2016) explored the forms through which Brazilian law addressed insider trading, outlining the administrative, criminal and private law enforcement tools. To assert whether investors in Brazil are dully repaired for information problems, Prado (2016) mapped the legal regimes applicable to disclosure violations and identified forms of repairing investor harm under different fields of law.

107 Such conclusion resulted from the author's preliminary research as described in footnote nº 21 above.

## 1. Competition law

Competition law is pertinent to address conflict of interests based on the hypothesis that the competitive pressure over investment advisors – thus, the fear of losing clients and market share for competitors – could serve as a counterincentive to biased advisory[108]. The fact that competition law applies to the investment advisory market, due to its cross-sector nature, could justify its pertinence to address conflict of interests, even if only indirectly, considering that competition law does not aim to solve individual legal disputes but, rather, issues that affect competition and the market overall – or, at least, a substantial part of it, as illustrated by EU competition law[109].

This hypothesis has been previously proposed in academic literature, such as Anagol, Cole and Sarkar (2016, pp. 33-34), who pointed out that, according to an empirical survey of life insurance advisory in India, competition between advisors can enhance the quality of services offered to clients. Similarly, Ottaviani and Inderst (2012, p. 501) argued that competition in the investment advisory market can increase advisors' incentives to attend to client suitability when recommending investment products.

While competition has been considered favourable to investor interests, some have pointed out that it is insufficient to protect investors from conflict of interests (*e.g.*, Ottaviani & Inderst, 2012, p. 504), since investors' information asymmetry hinder their capacity to identify problems in advisory services, thus, turning conflict of interests economically advantageous, even under the risk of occasionally losing clients to competitors[110].

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108 Competition is a collective right enshrined in a model of a free market economy, where market players can freely manage their own resources to offer goods and services, in view of generating incentives for lower prices, innovation, better quality, and greater diversity of choice for consumers (Whish & Bailey, 2011, pp. 4-5). This legal principle serves, on one hand, as a limiting factor to State intervention in the market and, on the other hand, as guidance for State intervention in exceptional circumstances to prevent and deter abuse of market power by said players (Pereira Neto & Casagrande, 2016, p. 27).

109 Article 102 of the Treaty on the Functioning of the European Union (TFEU) prohibits any abuse of dominance "within the internal market or in a substantial part of it (...) so far as it may affect trade between Member States". In other words, unilateral conduct from an undertaking that does not hold a dominant position or that does not affect trade between Member States is not encompassed by EU competition law. Additionally, in the merger control field, EU competition law applies only to concentrations that have a "Community dimension" (article 1(1) of Regulation (EC) nº 139/2004).

110 Ottaviani and Inderst (2012, p. 504): "*When consumers are naive about conflicts of interest, selling products with biased advice allows firms to generate the same perceived utility at lower cost. Importantly, firms are still jointly better off biasing advice even when there is compe-*

Therefore, a novel and plausible alternative is aiming the use of competition law to brokers, who can play a key role in shaping incentives toward or away from biased advisory. The route to do so would most likely be the legal provisions on unilateral behaviour. The trump card is finding the link between the investment platform's dominance and the source of biased incentives. Once that link is found, competition law becomes applicable.

In this hypothetical scenario, the legal tools available to investors are seeking public enforcement, through the filing of a complaint before the Brazilian competition agency (CADE) with request of conviction for an alleged anticompetitive infringement, and/or seeking private enforcement, through the filing of a standalone lawsuit in Brazilian courts with request of damages and/or specific performance. Given that section IV.3.a) below addresses judicial remedies, this section focuses solely on the antitrust tool of public enforcement (CADE).

To use this tool, the investor would have to "whistle blow" or file a petition before CADE against the platform that is believed to have abused its dominant position. To reach the complaint threshold stablished by Brazilian law, the investor would have to sufficiently detail the facts that, in his/her impression, constitute an anticompetitive infringement[111].

For an infringement to be found, CADE's General-Superintendency ("GS"), who bears the burden of proof, must prove that the defendant holds a dominant position and abused such dominance, as is the case of the European Commission in EU Competition Law. Once an infringement is found, the competition agency can apply a wide range of sanctions, which are non-exhaustively listed in the Brazilian Competition Act, including a fine of up to 20% of the company's turnover in the last fiscal year prior to the launching of the administrative proceeding[112].

However, this tool suffers from three main gaps. Firstly, in Brazil, as in most jurisdictions such as the EU, competition is a non-individualised collective right (*i.e.*, it does not protect individual legal interests). This means that competition law is only applicable when an act has a potential risk of affecting a significant portion of the market. In other words, considering that, in general, com-

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*tition. Thus, competition does not sufficiently protect consumers from exploitation. As consumers' perceived utility becomes inflated, demand becomes less elastic, allowing firms to earn higher profits by biasing advice even though the resulting total surplus is lower*. (...) *biased advice creates inefficiency*."

111 Article 66, § 1, of federal law nº 12.529/2011 allows for any party to file complaints before CADE, as long as the complaint is "reasoned".

112 Article 37, I, of federal law nº 12.529/2011.

petition law remedies only serve in specific circumstances where a minimum threshold of market power is involved[113], it only addresses conduct of very few market players – those who hold a dominant position[114].

Secondly, even if competition law is applicable due to the platform's dominant position, the claimant (investor) or the GS would have a challenging endeavour to prove that the investigated conduct constitutes an abuse under a competition perspective, *i.e.*, establishing a theory of harm that links the investment platform's dominance with its allegedly harmful conduct in incentivising biased advisory. Such theory of harm has never been presented to CADE – and, possibly, neither to other competition agencies worldwide. This makes proving a competition harm harder.

The abuse in such hypothetical case would be the use of rebate fees to favour issuers that pay higher fees to brokers and, thus, serve as additional bargain power by the broker to charge higher fees from issuers and investors. Arguably, rebate fees impose an additional layer of differentiation between investment products (some products may have a privileged status in advisor's recommendations due to their higher commission) and, therefore, allow investment platforms to favour certain investment products not based on the quality of the product, but, rather, on the issuer's economic capacity to pay higher fees to the broker. This is only possible because of the platform's dominance: if the platform was not dominant, the issuer could simply seek an alternative platform to distribute its securities. Similarly, the argument goes, investors bear high costs when using the platform because they lack reasonably equivalent platforms as alternatives.

As the description might suggest, the theories of harm used for such case has similarities from the ones used in known antitrust claims filed against big tech companies in the United States and in Europe, concerning online advertis-

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113 The requirement of a dominant position and the necessity to prove an anticompetitive effect in a substantial part of the market is present in most types of conducts subject to competition law prohibitions, but it is not the case of infringements by object or practices that are *per se* unlawful. The approach can vary per jurisdiction, but, generally, competition law waives the necessity to demonstrate dominance and effects for certain types of conducts, such as cartels and resale price maintenance practices.

114 Dominance is a legal concept that, in jurisdictions such as the EU and Brazil, means the capacity to operate in the market and raise its own profits independently of competitors and consumers (concept adopted in, *e.g.*, European Court of Justice's 1978 decision in *United Brands v. Commission* and the European Commission's guidance on article 102's enforcement priorities). It is the legal term equivalent to the economic concept of market power, which can be assessed through various criteria, such as market share.

ing[115]. The idea is similar, only in a different sector: a digital (investment) platform grows to an extent that it can overcharge either or both sides of the platform (exploitation). For issuers, the platform is attractive for hosting investment accounts of a wide pool of investors, while, for investors, the platform is attractive for offering a large portfolio of investment products.

To establish the theory of harm, the claimant or the GS could try to demonstrate that the brokerage fees or the advisory fees are set above a competitive level, meaning that, if there was more competition between investment platforms, investors would pay less for the brokerage and advisory services. Proving that would need a credible counterfactual scenario. Such endeavour would not be an easy task. If the theory of harm is fragile, the claimant has low chances of success, especially when a regulated market is in question and the competition agency is one that tends to adopt a cautious approach. The chances of CADE refraining from analysing the issue and delegating it to the Securities Commission are significant.

The third gap of this investor protection tool is its unsuitability for prevention and compensation purposes. Notwithstanding the growing use of interim measurers by CADE in technology-intensive markets (Pereira Neto, 2023), antitrust penalties serve a predominantly deterrent purpose, since antitrust investigations concern practices that are either present or past and fines are destined to the Fund of Collective Rights (*Fundo de Direitos Difusos* – FDD, for its Portuguese acronym), not directly to harmed investors.

## 2. Regulatory framework

### a. Regulation by the Brazilian Securities Commission and the National Monetary Council

The regulatory policy implemented by the Brazilian Securities Commission and the CMN are of a public sector-specific nature. Considering that investment advisors operate both on the securities market and on financial markets, they are subject to both the Securities Commission and the CMN. For a clear overview of the rules applicable to advisors in Brazil, in-depth research was conducted in CVM's and CMN's digital databases, where all documents issued by these agencies are available for public access, including norms and administrative case-law.

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115 *E.g.*, Case 1:23-cv-00108 (filed by U.S. State Attorney-Generals against Google, in January 2022), Case 1:21-md-03010-PKC (filed by the U.S. Department of Justice and U.S. State Attorney-Generals against Google, in January 2023).

This research was conducted with different search terms related to investment advisors in the referred online databases[116], without any automatic filters of type of document. After disregarding documents that were considered unrelated to the scope of the research[117] and repeated search results from the final set, there remained a total of 101 documents issued by the CVM and the CMN on investment advisors, including 15 regulations[118], 25 directives[119], 13 guidelines[120], 28 circular letters[121], 04 *circulares*[122], 01 explanatory note[123] and 14 rulings[124]. Despite not being issued by these regulators, the Brazilian Securities Law (federal law nº 6.835/1976) also appeared among the search results.

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[116] The search terms used were the following "*agente autônomo de investimento*"; "*agentes autônomos de investimento*"; "*assessoria de investimento*"; "*assessor de investimento*"; "*assessores de investimento*"; "*intermediação de investimento*"; "*intermediador de investimento*"; "*intermediadores de investimento*"; "*agente autônomo*"; "*agentes autônomos*". These terms were launched on 24/12/2020, 25/12/2020, 09/02/2021, and 15/02/2021, in the following official search engines: <https://www.bcb.gov.br/estabilidadefinanceira/buscanormas> <https://www.gov.br/cvm/pt-br/assuntos/normas> <http://conteudo.cvm.gov.br/legislacao/resolucoes.html> <http://conteudo.cvm.gov.br/legislacao/index.html>

[117] Some search results were ignored for not having potential relevance to this book's scope, such as norms and regulatory documents that regulated exclusively internal proceedings at the CVM or mentioned investment advisors only laterally, without really regulating them. Executive acts that had the sole purpose of granting individual requests of authorisation were also disregarded.

[118] Regulations nº 76/1967 (CMN), nº 95/1968 (CMN), nº 157/1970 (CMN), nº 238/1972 (CMN), nº 286/1974 (CMN), nº 293/1974 (CMN), nº 367/1976 (CMN), nº 494/1978 (CMN), nº 530/1979 (CMN), nº 1.058/1985 (CMN), nº 1.065/1985 (CMN), nº 1.987/1993 (CMN), nº 2.838/2001 (CMN), nº 11/2020 (CVM) and nº 16/2021 (CVM).

[119] Directives CVM nº 09/1979, nº 33/1984, nº 352/2001, nº 355/2001, nº 382/2003, nº 387/2003, nº 414/2004, nº 434/2006, nº 494/2011, nº 497/2011, nº 505/2011, nº 510/2011, nº 515/2011, nº 529/2012, nº 539/2013, nº 554/2014, nº 558/2015, nº 564/2015, nº 592/2017, nº 593/2017, nº 597/2018, nº 598/2018, nº 600/2018, nº 610/2019 and nº 617/2019.

[120] Guidelines or *ofício-circulares* CVM nº 01/2011, nº 04/2012, nº 02/2014, nº 03/2014, nº 01/2017, nº 01/2018, nº 04/2018, nº 02/2019, nº 05/2019, nº 06/2019, nº 01/2020, nº 02/2020 and nº 07/2020.

[121] Circular letters nº 626/1981, nº 665/1981, nº 718/1982, nº 767/1982, nº 773/1982, nº 806/1982, nº 814/1982, nº 856/1983, nº 880/1983, nº 911/1983, nº 1.028/1984, nº 1.082/1984, nº 1.090/1984, nº 1.097/1984, nº 1.149/1984, nº 1.173/1985, nº 1.204/1985, nº 1.266/1985, nº 1.318/1985, nº 1.473/1986, nº 1.511/1986, nº 1.580/1987, nº 1.617/1987, nº 1.649/1987, nº 1.687/1987, nº 1.769/1988, nº 1.815/1988 and nº 1.833/1988.

[122] *Circulares* nº 102/1967, nº 193/1972, nº 199/1973 and nº 229/1974.

[123] The only search result under this category was the CVM Explanatory Note nº 29/1984.

[124] Rulings nº 325/1999, nº 347/2000, nº 360/2000, nº 386/2001, nº 417/2001, nº 420/2002, nº 424/2002, nº 427/2002, nº 440/2002, nº 452/2002, nº 453/2002, nº 524/2007, nº 661/2011 and nº 689/2012.

While some of these documents have a biding and enforceable nature towards advisors, others have a merely guiding purpose for market players in general and advisors specifically, similar to the European Commission's notices in EU law. Two norms stand out as the relevant ones for concentrating core rules applicable to them: Reg. 178 (Regulation CVM nº 178/2023) and Regulation CMN nº 2.838/2001 ("Reg. 2.838").

As anticipated in chapter III, the rules applicable to advisors include the duty to "integrity, good faith and professional ethics", along with the extension of brokers' duties, such as the duty of loyalty towards the client. These duties are quite broad in scope, demanding an inevitable interpretative effort on a case-by-case basis to specify their meaning. To understand the extent of the legal tools available to investors in Brazil, one must understand the legal standards applicable to these duties.

According to the Securities Commission, these normative provisions are deliberately vague[125], allowing for the regulator's discretion when enforcing the law and adapting it to reach various forms of conduct adopted by advisors. The duties of loyalty, integrity, good faith and professional ethics work, therefore, as an umbrella. As anticipated in chapter III, conflict of interests intrinsically poses a risk to one's loyalty, integrity, good faith and professional ethics, meaning such advisor duties are infringed when the advisor favours its own interest or that of third parties in detriment of the investor's interest. No plausible interpretation of the meaning of loyalty, integrity, good faith and professional ethics could sustain a biased advisory service.

Furthermore, other regulatory duties applicable to advisors prohibit a biased act. Advisors' duties can be summarized in three types: suitability, transparency, and non-disclosure, beside ancillary duties, such as the duty to submit advertising material for the brokerage firm's previous approval. These categories, though not explicit in statutory provisions of the sector, help one understand how Brazil's State-regulated framework structured the standards of conduct for advisors.

Regarding the first category, when advising investors, the advisor must present the products that are most suitable to the investor's investment profile (pursuant to Resolution CVM nº 30/2021). To induce compliance to this duty, the regulatory rules prohibit various positions from advisors, among which,

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125 CVM, Administrative Proceeding nº 19957.006406/2016-09 (PAS), Defendants: *Le Valle Agente Autônomo de Investimentos S/S Ltda.* and Letícia Ferreira Duarte do Valle, Reporting Commissioner Gustavo Machado Gonzalez, ruled on 19/02/2018, reporting commissioner's order, p. 2.

representing the client before third parties, receiving assets or compensation from clients, outsourcing its services to third parties, and performing the role of asset manager, securities consultant or analyst in the securities market (pursuant to article 25 of Reg. 178).

Besides the suitability duty, advisors must attend to a series of fiduciary duties related to the own nature of their advisory services, given that, as mentioned earlier, Reg. 178 requires them to adopt "all the caution and diligence expected from a professional in their position" (article 24). These duties can be qualified as a general duty of transparency, though not explicitly referenced like this in the law.

By transparency, this means that, regardless of the product's suitability with the client's profile, the advisor must provide all relevant information for clients to make a decision and act in a transparent manner about the reasons, standards and objectives of their conducts when assisting investors. For example, an advisor must inform the investor about the risks and costs of the investment products in which he or she is interested in, regardless of whether that product is suitable.

Accordingly, the 2021 public hearing in which the Securities Commission discussed the reform of investment advisory regulation (*Audiência Pública SDM nº 05/2021*) proposed an amendment according to which brokers would be obligated to display clear, concise and easily accessible information about their own remuneration in a publicly accessible webpage. Though referring to brokers' compensation conditions, not advisors', this amendment contributes to greater transparency, since advisory fees are based on brokerage fees, as explained in chapter III. The proposal was implemented through Regulation CVM nº 179, which came in force in January 2024, but, despite requiring brokers to public display their own compensation criteria, explicitly limits such obligation to the "general terms and parameters" of remuneration and not "amounts and percentages effectively adopted by the broker".

Another duty of transparency is Annex A of Reg. 178, which consists of a term of consent to be signed by the client before using advisory services, including the consent to the fact that "the investment advisor's interests may conflict with mine, especially due to the way through which he is compensated by my investment decisions" (item 3 of Annex A of Reg. 178). Additionally, Reg. 178 also requires advisors to inform clients about potential conflict of interests when they continue advising clients under new brokerage firms (article 9).

Finally, the third type of duty advisors have in the State-regulated framework is the non-disclosure of confidential information accessed during professional activity (article 23, § 1, II, of Reg. 178). Once more, the regulator adopted a broad approach and did not specify what information could have a confidential nature. Despite this broad scope, there are parameters that allow one to qualify certain information as confidential, which is the case of Complementary Law nº 105/2001, addressing the duty of financial institutions to preserve the confidentiality of its financial operations and services, and the Securities Commission's administrative case-law, which considers investor's account balance, personal data, client's individual registration form, and payment slips regarding broker fees as confidential information[126].

Although these three categories of advisors' duties do not explicitly address conflict of interests related to payment conditions, two of these – namely, suitability and transparency – sufficiently serve as basis to qualify biased advisory as a regulatory infringement. The advisor's biased conduct – *i.e.*, seeking its own individual interests or those of third parties in detriment of the investor's – will potentially (i) disregard the product's suitability to the client's individual profile and (ii) conceal the real costs bore by the client (even if only trade-off costs instead of a measurable financial loss) when investing under such advisory, undermining the general duty of transparency.

The concern of designing these duties to reach biased conducts is explicit in the report issued by the Securities Commission for the 2010 public hearing (*Audiência Pública SDM nº* 03/2010)[127]. Therefore, although the regulatory framework does not explicitly forbid biased advisory, it provides sufficient provisions to ground such conduct as a regulatory infringement.

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126 CVM, Administrative Proceeding nº 19957.000250/2017-25 (PAS), Defendants: *Wall Trader Agente Autônomo de Investimento Eireli* and others, Reporting Commissioner Gustavo Machado Gonzalez, ruled on 02/04/2019, reporting opinion, pp. 4-5.

127 For example, when reasoning the rule that prohibits advisors from acting on behalf of clients, the Securities Commission stated that "[the] CVM considers that such possibility creates highly concerning conflicts of interests – (...). Putting advisors in the position of representatives of clients, even if only in registration forms, implies stating that the investment orders come from the advisors. (...) If the advisor is the source of the investment order, the chain of acts that allows for the resolution of occasional conflicts is overseen. Moreover, that admission creates the presumption that the advisor manages the client's investment account, which is currently prohibited – it is not admissible that a professional hired by the intermediary [broker] for distribution activities and usually remunerated based on the amount of transactions can occupy the position of representative, assignee, or asset manager of the client." (author's translation, original in Portuguese) Available in: <http://conteudo.cvm.gov.br/audiencias_publicas/ap_sdm/2010/sdm0310.html> Access on: 03/12/2023.

In these occasions, the legal tool available for investors is the filing of a formal complaint to the Brazilian Securities Commission, which has jurisdiction to investigate and administratively prosecute these infringements[128]. To identify the gaps of investor protection in this framework, it is necessary to analyse how the Securities Commission interprets these duties and enforces these rules.

The case-law research was done by the author in two levels, firstly encompassing Commission rulings that referenced the advisory profession in conjunction with terms related to conflict of interests[129] and, secondly, precedents of “churning” infringements by advisors, which consists of promoting excessive transactions (turnover) with the client’s account in order to generate more fees, regardless of the client’s interest and risk profile[130].

The choice to focus on churning was because these are precisely the cases where the Securities Commission approaches the interface between conflict of interests and suitability, *i.e.*, the subtle biased advisory that contradicts investor suitability, as noticed by the lack of pertinent results in the first stage of the case-law research. Most of the CVM’s case-law regarding advisors’ misconduct concerns infringements of lack of previous registration, management of clients’ accounts, and executing investment orders without the client’s previous consent. Since one of the forms of churning is by the advisor simply

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128 Pursuant to articles 8, subsection III, and 9, subsections V and VI, of federal law nº 6.385/1976.

129 The research was conduct on 07/10/2021, with the following search terms in CVM’s advanced research tool: <“*agente autônomo*” and “*conflito de interesse*”>; <“*agente autônomo*” and “*conflitos de interesse*”>; <“*agente autônomo*” and “*probidade*”>; <“*agente autônomo*” and “*ética profissional*”>

130 The following search results appeared in the Securities Commission’s advanced research database, on 27/12/2021: Administrative Proceeding nº 11/2013 (PAS) (Reporting Commissioner Gustavo Gonzalez, Defendants: *Geração Futuro Corretora de Valores* S.A. and other, ruled on 30/01/2018); Administrative Proceeding nº SP2007-0051 (Reporting Commissioner Luciana Dias, Party: Marcos Antônio Reis, ruled on 23/02/2012); Administrative Proceeding nº SP2012/0480 (PAS) (Reporting Commissioner Roberto Tadeu Antunes Fernandes, Defendants: A.S. *Consultoria Imobiliária Ltda.* and others, ruled on 06/10/2015); Administrative Proceeding nº RJ2014/2797 (PAS) (Reporting Commissioner Pablo Renteira, Defendants: *D&F Agentes Autônomos de Investimentos Sociedade Simples Ltda.* and others, ruled on 27/09/2016); Administrative Proceeding nº SP2014/0465 (PAS) (Reporting Commissioner Gustavo Gonzalez, Defendant: Pery de Oliveira Neto, ruled on 06/11/2018); Administrative Proceeding nº 22/2013 (PAS) (Reporting Commissioner Gustavo Gonzalez, Defendants: *Um Investimentos* S.A. CTVM and others, ruled on 18/09/2018).

recommending investment products unsuitable to the client's profile, this infringement encompasses the subtle cases in which legal response can be tricky for retail investors.

Two cases of the Commission were found to suit these standards, where the authority framed as unlawful the act in which the advisor sought higher compensation by neglecting the investor's risk profile. The first case was an investigation about an individual advisor and the firm to which she was associated, who jointly promoted transactions without the client's consent or with the client's misinformed consent, in order to raise brokerage fees and, consequently, advisory commission[131]. The CVM convicted the defendants and considered their conduct incompatible with the standard of the duty of integrity, good faith and professional ethics.

In another case[132], though not explicitly based on the duty of integrity, good faith and professional ethics, the Securities Commission convicted an advisor based on churning committed solely through the recommendation of unsuitable products to the client, without accompanying infringements. This case is particularly interesting because the authority recognized the existence of churning without the advisor having managed the client's account, unlike most precedents of the Securities Commission. In the case, the client's misinformed consent to numerous transactions unsuitable to the client's profile was enough to reach a standard of proof for conviction[133]. In addition, the Commission also recognised the bond of trust that underlines (or should underline) the relationship between advisors and investors[134].

These two cases are relevant to demonstrate that the Securities Commission recognises the existence of conflict of interests and the violation of the duty of integrity, good faith and professional ethics when advisors aim higher compensation by recommending transactions unsuitable with the client's profile. However, two cases are not enough to form a consolidated case-law about the issue. The reasons for such few cases in which the Securities Commission has addressed the topic can be many. One can argue that few infringements were

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131 CVM, Administrative Proceeding nº 19957.006406/2016-09 (PAS), Defendants: *Le Valle Agente Autônomo de Investimentos S/S Ltda.* and Letícia Ferreira Duarte do Valle, Reporting Commissioner Gustavo Machado Gonzalez, ruled on 19/02/2018, reporting commissioner's order, pp. 2-3.

132 CVM, Administrative Proceeding nº SP2014/0465 (PAS), Defendant: Pery de Oliveira Neto, Reporting Commissioner Gustavo Machado Gonzalez, ruled on 06/11/2018.

133 See footnote above, Reporting Commissioner's opinion.

134 See footnote above, Reporting Commissioner's opinion.

committed in Brazil or, if they were, they were not taken to the Commission by the involved parties or they may have been taken, but their investigations are being conducted confidentially.

Regardless of the motive for such incipient case-law, the conclusion is that the Brazilian Commission appears to have little experience in prosecuting the subtle forms of biased advisory, where advisors mislead investors by providing unsuitable recommendations in view of obtaining higher compensation. In addition, according to the search results, the Brazilian Commission has never applied brokers' duty of loyalty by extent to advisors, as provided by article 31 of CVM's Resolution nº 35/2021[135].

The Brazilian Commission's proceedings usually address more explicit forms of conflict of interests or infringements where proving such conflict is irrelevant for conviction, such as the infringement to operate as an advisor without prior registration before the Commission and Ancord. This reveals a potential blind spot in the Commission's role, since investors will usually see administrative investigations of misleading advisory only if the advisor lacked mandatory registration, violated the client's confidentiality or operated the client's account without explicit consent. Misleading recommendations that disregard the investor's suitability do not face the same institutional position of deterrence.

An incipient case-law about a certain topic does not necessarily mean that the issue will not be addressed and that the law will not be enforced. As stated above, the Brazilian regulatory framework provides sufficient normative basis to frame such subtle biased advisory as infringements, as exemplified by then Commissioner Gustavo Machado Gonzalez while ruling the referred Administrative Proceeding nº SP2014/0465.

However, the incipience of case-law at the agency responsible for administratively investigating, prosecuting and convicting these infringements can reveal three problems: (i) investigators' and commissioners' lack of familiarity with this form of infringement, thus, serving as a practical obstacle for an effective regulatory deterrence, (ii) insufficiency of resources to address demands under its jurisdiction, inevitably leading the agency to prioritize prosecution of

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135 Although the duty of loyalty is currently provided by Resolution nº 35 of 2021, prior rules from the Securities Commission already established this duty, such as Directive CVM nº 505/2011 and Directive CVM nº 387/2003. In research conducted in CVM's database on 10/03/2022, with the joint terms "*dever de lealdade*" and "*agentes autônomos de investimento*" or "*agente autônomo de investimento*", the only cases where the CVM approached the duty of loyalty was in relation to corporate managers before publicly traded companies, not in relation to advisors before clients. Administrative Inquiry nº 01/98, Administrative Proceeding nº 01/2010 and Administrative Proceeding nº RJ2012/11002.

some types of infringements in detriment of others, and/or (iii) a predominant interpretation according to which these more subtle forms of conflict of interests do not configure as infringements or do not meet the standards of proof to convict firms and individuals in Brazil[136].

Asserting which one of these problems (or even all of them) actually exist in Brazil to justify the incipient case-law overruns this book's purpose. However, having them in mind is useful to understand the gaps in the State-regulated framework of investor protection. Though it provides a relevant tool for convicting misconduct in investment advisory – complaint before the Securities Commission –, such tool can face practical limits in the attempt of prosecuting that type of infringement.

Despite the high expertise of the CVM's civil servants and commissioners, as well as the agency's effort to fulfil its roles in the Brazilian securities market, its policy appears to have a certain blind spot, since the agency lacks a consolidated institutional experience and a robust case-law parameter to address subtle biased advisory that take place under a veal of lawfulness (*i.e.*, biased advisory with duly registered advisors, no management of the client's account, and no violation of confidentiality and ancillary statutory duties).

### b. Market regulation by the stock exchange oversight board

In case the investor considers him/herself harmed by biased advisory, he or she can also seek the Mechanism of Investors' Compensation ("MIC", or "MRP" for its Portuguese acronym) of the Brazilian stock exchange's oversight board (*BM&F Bovespa Supervisão de Mercados* – BSM). The BSM serves as an oversight board of the Brazilian stock exchange (B3), overseeing market players' compliance with self-regulation and applying administrative penalties for market misconduct.

The MIC's role is to compensate investors for harms suffered while investing in securities in the Brazilian stock exchange or using services of custody, due to conduct or omission by intermediary service providers (CVM, 2021*b*, p. 5), such as brokers and their representing agents, including investment advisors. The use of the MIC by investors is only accepted in these specific circumstances, meaning harms suffered from transactions involving fixed income assets or as-

[136] The lack of clear standards of proof leads to, on one hand, less legal certainty for advisors that may face charges of infringement in future cases and, on the other hand, less willingness from the enforcement authority to engage in deterrence, due to the difficulty in, *e.g.*, defining individual investor suitability on the case and differentiating conflict of interests from mere imprecise investment advice.

sets traded in the over-the-counter market are not covered. The compensation that harmed investors are entitled to request to the MIC is limited to a cap and subject to an 18-month deadline from the date the harm was originated, both of which (cap value and deadline) are jointly defined by the BSM's Self-Regulation Board and the Securities Commission[137].

Since it is a fund for compensating harmed investors, the MIC has a solely compensatory role in cases of biased advisory services, mitigating or repairing the damage suffered by investors on such occasions. Despite its relevance, the MIC faces three limits in its role as an investor protection tool, beside the compensatory cap and the deadline mentioned above.

Firstly, by having a strictly compensatory purpose, the MIC does not perform a preventive or deterrent role against biased advisory services, unless, after the MIC's compensatory proceeding, the BSM decides to launch an administrative probe against those responsible for the harmful biased services or send a notice to the Securities Commission, further leading to the enforcement mechanisms explored in the previous section. When a protection tool serves only a compensatory purpose against a certain problem, this tool, by itself, does not contribute in any sense to the reduction of the referred problem. It ends up only addressing its effects, not its cause.

Secondly, even if looking only into its relevant compensatory role, the MIC still faces limits for a plain investor protection, because investors' requests for compensation are hardly cleared by the MIC. By researching in BSM's database, it was verified that, out of a total of 54 compensation requests by investors involving investment advisors, only 10 were fully or partially granted (18,5%), while 40 were dismissed (74%)[138].

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137 Until the MIC's new internal regulation, which came into force in August 2023, the cap for investor compensation was explicitly set in the value of BRL 120.000,00, pursuant to article 3 of the previous internal regulation. Currently, as of January 2024, the cap has been increased to BRL 200.000,00. Regarding the deadline for a request for compensation to be filed by the investor, the 18-month period is provided by article 4 of the MIC's 2023-issued internal regulation and article 127 of Resolution-CVM nº 135/2022.

138 Research made on 11/03/2022, in MIC's public digital database. In the section of complaints as of 2019 ("*Reclamações ao MRP a partir de* 2019"), no search filters were used. In the section of complaints filed until 2018 ("*Reclamações ao MRP até* 2018"), the search filter of causes related to irregular activity of investment advisors was used. Accessed platform: <https://www.bsmsupervisao.com.br/RessarcimentoDePrejuizos/AcompanheSuaReclamacao>

On an exclusive interaction with the BSM team[139], this self-regulatory board provided a completer and more detailed database than the one publicly available in the BSM's website. According to the provided database, which extends to unequivocally all investor compensation requests filed from 2008 to 2021, there were 296 requests underlined by claims concerning investment advisors. Given that this timeframe amounts to 14 years, this number of requests does not seem significant in contrast to the size of the Brazilian securities market and number of investors operating in it – 296 requests mean an average of 21 requests per year.

Of these 296 compensation requests, only 44 were fully or partially granted, while 234 were dismissed (159 were dismissed on the merits and 75 were preliminarily dismissed due to unattendance of formal requirements, such as deadline and admitted conditions of compensation). In other words, 79% of the investor compensation requests were dismissed. These results are summarized in table 5:

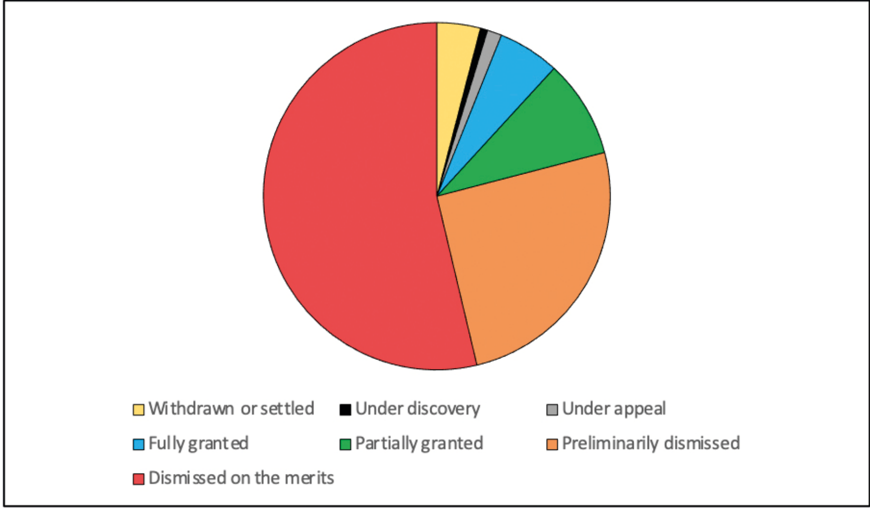
**Table 5 – Mapping of investor compensation requests filed before the MIC and underlined by claims concerning investment advisors (2008-2021)**

| **Decision toward investor compensation requests underlined by claims concerning investment advisors** | **Number of requests** |
| --- | --- |
| Withdrawn or settled | 12 |
| Under discovery | 2 |
| Under appeal to the CVM | 4 |
| Dismissed on the merits | 159 |
| Preliminarily dismissed | 75 |
| Partially granted | 27 |
| Fully granted | 17 |
| **Total** | **296** |

[139] Two methodological motives led the author to reach out to the BSM team for an exclusive inquiry. Firstly, the online search results displayed the outcome of the MIC proceedings as concluded ("*arquivamento*"), without clarifying whether the compensation requests were granted or dismissed. Secondly, despite the possibility of using the search filter of investment advisors ("*atuação de agente autônomo*"), there were separate search filters about churning infringements and conflict of interests, which encompassed proceedings not only about investment advisors.

As the data above demonstrates, regardless of the database used as reference (either the publicly displayed or the one provided by the BSM for this book), the level of dismissals for investor compensation requests is over 70% at the MIC. This is an empirical finding that well succeeded investor requests are less frequent than one could imagine by simply looking at the law in the books. The reasons for such high level of downfalls in investor requests can be many, some of which not even attributable to the BSM. However, identifying these reasons would demand an individual analysis of each case and their records are undisclosed, reason why the source material was insufficient for such purpose. The proportion of dismissals is systematized in graph 1 below:

**Graph 1 – Proportion of investor compensation requests' outcomes in cases concerning investment advisory (2008-2021)**




Source: Author's creation

Regardless of the reasons that underline this high level of dismissals at the MIC, this data is enough to assert that investors who suffered harm due to any type of biased investment advisory service tend to face a hard pathway for compensation at the market-regulated framework.

A third limit to the MIC as an investor protection tool is the low awareness of investors on how to access the MIC or even its existence for compensation purposes, as recognised by the CVM (2021b, p. 5). The numbers shown above, according to which only 296 requests concerning investment advisory were filed in a timeframe of 14 years (average of 21 requests per year), support this assertion.

The BSM has made considerable effort in social media and other communication tools to expand investor awareness of the MIC as a compensation tools[140], but the lack of widespread knowledge of this fund by investors in general is still a persistent reality, especially considering the fact that, according to the database provided by the BSM, the last years were the ones with the fewer number of compensation requests concerning advisory services[141].

In summary, the BSM has a distinctive role as a market-regulated oversight board, with enforcement mechanisms against misconduct and a compensation mechanism under the MIC. However, the MIC has gaps of its own under a plain investor protection perspective against biased advisory services, mainly because it has a high level of dismissals of investor compensation requests, it has a purely compensatory purpose – thus, not fulfilling a role of preventing conflict of interests –, and it is not widely known among investors in Brazil.

## 3. Private law

### a. Tort law

Identifying what rules fall under the private law framework is a first step to identify what protective legal tools are available for investors. Given the broad scope of private law, many rules can apply to the investor-advisor relation. A first applicable norm is the Brazilian Civil Code (federal law nº 10.406/2002), which regulates business and non-business transactions between private parties.

Besides the Civil Code, Brazil has a solid consumer protection framework that falls under the scope of private law. Whether the investors-advisor relation is legally considered a consumer-supplier relation for consumer protection purposes is subject to controversy in Brazil. The application of the Brazilian Consumer Protection Code (federal law nº 8.078/1990) demands that some party- and transaction-related requirements are met. If these conditions are met, the Consumer Protection Code is mandatorily applicable to the transaction, since it is a biding norm, pursuant to article 1 of the Code. These conditions are

140 Pursuant to material shared by the BSM's Management of Data and Governance, on April 2022, as well as the institution's activities on social media, the BSM team has been intensely promoting investor awareness of the MIC, in platforms such as X, Facebook, Instagram, YouTube, and LinkedIn, along with the institutional cooperation with the Brazilian Securities Commission to promote the MIC on the platform investidor.gov.

141 The year of 2021 had only three requests concerning advisors, while 2020 had only four, in contrast with, for example, the years of 2017 and 2010, which had, respectively, 29 and 59 compensation requests.

(i) the position of consumer and supplier of each party (party-related requirement) and (ii) the existence of a consumer relation between them (transaction-related requirement).

The main source of controversy in framing an investor-advisor relation into the consumer protection framework is qualifying an investor as a consumer. According to article 2 of the Consumer Protection Code, "a consumer is every individual or legal entity who acquirers or uses a product or service as its end user"[142]. Based on Brazil's legal doctrine[143] and case-law[144], a person or entity is in the position of end user if the product or service is acquired or used as final recipient under a factual perspective – *i.e.*, without passing it on to third parties – and under an economic perspective – *i.e.*, without an intent to profit.

On one hand, as described in chapter III, investment advisory services have the core purpose of attending to the client's patrimonial interests. Therefore, one can argue that investors are in the position of end users and, thus, of consumers. Retail investors, which are the focus of this book, do not operate their investments as their business, enabling one to argue that they are not part of the supply chain of investment products – a chain which must have some end users and little sense would there be in naming anyone other than the retail investor.

On the other hand, given that, in the securities market, an investor acquires an investment product seeking to obtain an economic gain – either by further selling this product in the secondary market for a higher price or by obtaining capital return in the position of a company's shareholder or an investment fund's stockholder –, one can argue that an investor, even a retail one, is not an end user under an economic perspective.

To solve this dilemma, Brazilian courts' case-law serves as a parameter. Courts have applied the Consumer Protection Code in favour of unexperienced investors in a handful of cases, based on the investor's vulnerable position towards intermediary service providers[145]. Among these cases, the Code has been used specifically to address disputes between investors and advisors or

142 Author's translation from the statutory provision: "*Art. 2º Consumidor é toda pessoa física ou jurídica que adquire ou utiliza produto ou serviço como destinatário final.*"

143 *E.g.*, Tartuce F, Neves DA (2016) Manual de direito do consumidor: direito material e processual. 5th edn. Método, São Paulo, p. 88.

144 *E.g.*, STJ, case nº 1.266.388/SC (*REsp*), Fourth Chamber, Reportig Justice Luís Felipe Salomão, ruled on 17/12/2013. STJ, case nº 1.321.614/SP (*REsp*), Third Chamber, Reportig Justice Paulo de Tarso Sanseverino, ruled on 16/12/2014.

145 *E.g.*, STJ, case nº 1.785.802/SP (*REsp*), Third Chamber, Reporting Justice Ricardo Villas Bôas Cueva, ruled on 19/02/2019.

brokers[146]. In addition, the consumer protection framework has been applied by courts to investors in the real estate market[147], in banking services[148] and even in cases of minority shareholders[149], demonstrating the wide reach of the Brazilian consumer protection law.

Therefore, even if investors are not considered end users by concept, the Consumer Protection Code could still be applied to biased advisory cases based on Brazilian case-law according to which consumer defence is exceptionally applicable to vulnerable parties that are not necessarily end users (a doctrine known as "mitigated finalist theory" or "*teoria finalista mitigada*")[150]. Thus, in this book, investors are legally considered consumers, for argument's sake.

The party-related requirement for the application of consumer law is two-folded, encompassing not only the consumer side, but, also, the supplier side. Article 3 of the Consumer Protection Code provides a broad concept of supplier, encompassing, also, individuals and legal entities that develop any activity of service supply. Investment advisors, even if associated to an advisory firm, fit into this legal definition. Even though advisors operate as a broker's *longa manus* (see chapter III above), advisors perform an economic activity of their own and have their own legal personality while not integrating the broker's hierarchical structure. Therefore, qualifying brokers as suppliers does not unable the same qualification to advisors.

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146 *E.g.*, TJ-SP, Appeal case nº 1117916-39.2017.8.26.0100, 14th Chamber of Private Law, Reporting Appellate Judge Carlos Abrão, ruled on 12/08/2020; TJ-SP, Appeal case nº 0016400-35.2013.8.26.0196, 15th Chamber of Private Law, Reporting Appellate Judge Luiz Arcuri, ruled on 17/02/2016. For an empirical study on the application of the Consumer Protection Code to disputes concerning investment platforms and advisors, see DUTRA, Marcos Galileu L.; PRADO, Viviane M.; GRUPENMACHER, Giovana T. A dinâmica da aplicação do CDC na relação entre corretoras e investidores. *Revista de Direito do Consumidor*, v. 139. n. 31, pp. 151-178. São Paulo: Ed. RT, jan.-fev./2022. Available in: <http://revistadostribunais.com.br/maf/app/document?stid=st-rql&marg=DTR-2022-3893> Access on: 03/12/2023.

147 *E.g.*, STJ, case nº 1.878.330/RJ (*AgInt no AREsp*), Fourth Chamber, Reporting Justice Antônio Carlos Ferreira, ruled on 30/08/2021; STJ, case nº 1.785.802/SP (*REsp*), Third Chamber, Reporting Justice Ricardo Villas Bôas Cueva, ruled on 19/02/2019.

148 *E.g.*, STJ, case nº 1.131.073/MG (*REsp*), Third Chamber, Reporting Justice Nancy Andrighi, ruled on 05/04/2011.

149 *E.g.*, STJ, case nº 1.685.098/SP (*REsp*), Third Chamber, Reporting Justice Moura Ribeiro, ruled on 10/03/2020.

150 *E.g.*, STJ, case nº 646.466/ES (*AgRg no AREsp*), Third Chamber, Reporting Justice Moura Ribeiro, ruled on 07/06/2016.

Furthermore, the Consumer Defence Code encompasses any type of market activity that can impact consumers, having the Brazilian Federal Supreme Court previously applied it to banking and financial services in general[151], based on statutory provision[152]. Therefore, by legal coherence, consumer law should equally apply to the investor-advisor relation. Alternatively, even if it was not legally considered a consumer-supplier relation, consumer law could still be evoked under article 29 of the Consumer Protection Code, which provides legal remedies for third parties who have suffered damage due to a supplier's activity and, thus, are legally equated to consumers.

Having checked the party-related requirement off the list, there remains a final task of fulfilling the transaction-related requirement. It usually occurs along with the party-related verification, since an interaction between a consumer and a supplier is usually for consumption purposes. However, in the investor-advisor relation, a possible debate is the lack of direct compensation from the investor to the advisor – a transaction which is forbidden under Reg. 178, as indicated in chapter III. One could question whether the lack of payment from the consumer to the supplier could impede the application of consumer law, since article 3, § 2°, of the Consumer Protection Code requires "remuneration" for a supplier's activity to be legally qualified as a service provision.

However, Brazilian courts have a solid and longstanding interpretation that this statutory provision includes cases of indirect compensation, *i.e.*, when the consumer pays for another party or service that indirectly leads to the supplier's compensation[153], which is the case of advisors' compensation, as detailed in chapter III.

In summary, the private law framework, in regard to statutory tort law, is mainly governed by the Brazilian Civil Code and the Consumer Protection Code. Additional norms can be occasionally applicable, depending on the specific context of each case. Having this framework in mind, we now pass to the rights and obligations applicable to the investor-advisor relation. Regarding conflict of interests, two hypothetical scenarios must be distinguished:

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151 *E.g.*, STF, case n° 2.591-1-DF (*ADI*), plenary session, Reporting Justice Carlos Velloso, ruled on 07/06/2006.

152 Article 3, § 2, of the Consumer Protection Code.

153 Example of cases where this interpretation was sustained by the Brazilian Superior Court of Justice are case n° 566.468-RJ (*REsp*), Fourth Chamber, Reporting Justice Jorge Scartezzini, ruled on 23/11/2004, and case n° 1.347.473-SP (*AgInt no REsp*), Fourth Chamber, Reporting Justice Luís Felipe Salomão, ruled on 04/12/2018.

- **Scenario 1:** the investor who uses investment advisory services lacks any knowledge about the advisors' compensation conditions, either for not knowing that the advisor earns fees on a variable basis or, despite knowing this criterion, does not know how this variation occurs and what investment products are more profitable to the advisor.
- **Scenario 2:** the investor who uses investment advisory services is plainly informed about the advisor's compensation conditions, having all the information required to identify a biased advisory service, even the subtle ones.

Considering these two scenarios, one can notice that both investors suffer from risk of biased advisory. Regardless of whether such conflict of interests does take place and influences the advisor's actions, the possibility of it exists – *i.e.*, the risk may vary according to various factors, such as the advisor's individual moral constraints, but the conflicting incentives exist. Despite this overlapping aspect between the two scenarios, the first investor lacks the necessary information about the main source of the conflict of interests: the advisor's compensation conditions. By not knowing these conditions or how they operate, the investor lacks information about an aspect that can impact his/her patrimony.

As explained previously, the circumstances of most investor-advisor relations in Brazil fit the first scenario, *i.e.*, regardless of whether biased advisory does take place, the investor lacks information about the advisor's compensation conditions that could potentially lead to conflict of interests.

The scenarios described above have two legal issues addressed by tort law: poor information for consumers and risk of biased advisory. Even in scenario 2, in which the investor is plainly informed about the advisor's compensation criteria, the investor would bear high monitoring costs over the advisor's conduct, since identifying biased advisory demands the capacity to monitor the recommended products' suitability, which the investor does not have, otherwise he/she would not have hired the advisor in the first place. To address these issues, an investor can seek courts (or arbitration, if contractually applicable) and plea for specific performance and damages, as detailed further below.

As for the lack of (or poor) information, when the information concerned is central to the transaction between the parties, it can be considered a flaw in the services provided to the consumer. The Consumer Protection Code, in its article 6, subsection III, considers "adequate and clear information about the products and services" as a basic consumer right. In legal terms, it is possi-

ble to qualify the lack of detailed information about an advisor's compensation conditions as a flawed service, because, although it does not turn the service inadequate for consumption or reduce the service's market value (conditions to qualify a service as unlawful for consumer protection purposes), it creates a disparity between what was advertised to the client and what is effectively being offered to him/her.

Specifically, as described in the previous chapter, the hiring of advisory services assumes an alignment of interests between the advisor and the investor. Thus, in the absence of disclaimers alerting the opposite, the hiring of advisory services assumes the advisor's alignment with the investor's interests. If the advisor's compensation conditions have the potential to generate biased advisory, as demonstrated in chapter III, these compensation conditions contradict the advertisement initially made to the client (or simply the underlining assumption of the hired services), reason why the lack of clear and detailed information about the compensation conditions becomes unlawful under article 20 of the Consumer Protection Code.

In theory, as this article rules, once the consumer is able to prove the flawed service, it can choose between the following remedies: (i) a new performance of the previously provided service, when possible, but without charge to the consumer; (ii) the immediate reimbursement of the amount paid by the consumer, monetarily adjusted, notwithstanding the possibility of claiming damages; and (iii) the deduction of the equivalent value of the flawed service from the price charged from the consumer.

However, these remedies would not be useful in the context of the investor-advisor relation, for the following reasons. Regarding remedy (i), the dynamic nature of the securities market hinders any attempt of performing the hired services in the same conditions in which it was hired in the first place – *e.g.*, stock rates, risks and value of investment products would not be the same comparing to the moment in which the biased advisory took place. Furthermore, even if market conditions were hypothetically the same, reperforming the service would not solve the investor's problem, since the conditions that lead to the biased advisory (compensation conditions) would persist. Thus, reperformance could even enhance the investor's harm. In respect to remedies (ii) and (iii), considering that investors do not pay advisors directly, as shown in chapter III, there is no price of paid amount to discuss, reason why reimbursement and deduction are inadequate solutions.

Therefore, the remedies provided by the Consumer Protection Code in response to flaws do not adequately fit the case of biased advisory services for investors. The consumer protection tools appear to be of little use for investor

protection against conflict of interests. Its pertinence in favour of investors in court litigation is at the procedural aspect, since consumer law shifts the burden of proof in favour of the consumer/plaintiff – *i.e.*, on a scenario of insufficient evidence, the investor's allegations are assumed truthful in the judicial proceeding, reducing the investor's discovery costs (addressed further below)[154].

Beside these remedies, the investor can file a lawsuit with request for specific performance, based on the referred statutory provisions of right to adequate information. In such case, the investor could request the court to order the disclosure of his/her advisor's compensation conditions, arguing that this information is essential for the use and monitoring of the hired advisory service. However, this tool also faces limitations of its own. While there is an inevitable unpredictability of the outcome due to lack of a consolidated case-law in Brazilian courts about this topic and the risk of dismissal depending on the judge's position about the advisor's right to secrecy, filing such lawsuit would have a practical effect of diminishing some level of trust and dialogue that may remain between the advisor and the investor.

Alternatively, still under the private law framework, the lack of information about the advisor's compensation conditions to the investor could arguably be a case of error, under the terms of the Brazilian Civil Code. Transactions originated from a party's substantial error are null and void[155]. The investor's unawareness of an important aspect such as the advisor's compensation conditions can be considered a substantial error, since it regards essential information about the services agreed between the parties[156] – the compensation conditions are essential because, as explored in chapter III, it shapes the incentives of a market agent, even if not the only one, thus, impacting the parties' alignment of interests and potentially impacting the client's patrimony.

On the matter of damages, in Brazil, investors tend to pursuit legal remedies only after they have effectively suffered economic loss. Any harm caused by an investment advisor to an investor is reparable under tort law, pursuant to ar-

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154 The shift of the burden of proof is considered a basic consumer right, pursuant to article 6, VIII, of the Consumer Protection Code. Without the application of this Code, shifting the burden of proof in court proceedings would still be possible, based on article 373, § 1, of the Civil Procedure Code, but it depends on the court's discretion to grant it and it is applied on an exceptional basis, because it would depend on the investor's impossibility or excessive difficulty in producing evidence. Thus, using the Consumer Protection Code would be more favourable to the investor/plaintiff, given that shifting the burden of proof is the rule, not the exception.

155 Pursuant to article 138 of the Civil Code.

156 Pursuant to article 139 of the Civil Code.

ticles 186 and 927 of the Brazilian Civil Code, serving as an additional investor protection tool against conflict of interests. This means that, when an investor suffers economic loss, moral damage, loss of an expected profit or merely loses the opportunity of an economic gain (*perda de uma chance* theory), the investor can file a lawsuit before the court in pursuit of damages. Such lawsuit can be filed towards the advisor and/or the brokerage firm to which the advisor is related, since brokers are liable for damage caused by its investment advisors[157].

Besides the possibility of the investor filing the lawsuit individually, investor protection can also be pursued judicially through collective claims (class actions), whose entitled entities are the Brazilian Public Prosecutor's Office (*Ministério Público* – MP) or a class-representation entity related to investors' interests. A class action for this purpose would be based on the Consumer Protection Code (article 81), if consumer law is ruled applicable, or on federal law nº 7.347/1985, which governs class action lawsuits beyond consumer relations[158]. Hypothetically, if the MP concludes that the current compensation conditions in Brazil are propellers of biased advisory, it could propose a class action, *e.g.*, requesting disclosure of compensation criteria and/or fine for abusive market practices.

However, the investor protection tools provided by tort law, either through individual lawsuits or class actions, require an effective or potential damage suffered by the investor, reason why these are *ex post* tools, *i.e.*, they come in-handy after biased advisory services caused some type of harm to the investor. Although injunctions are possible (and do, in fact, take place) in Brazilian courts to protect the plaintiff's interest *ex ante*, the investor's legitimacy to plea (an admissibility requirement to file a lawsuit, pursuant to article 330 of the Civil Procedure Code) is conditioned to the imminence of harm. Therefore, tort law fulfils a limited role in preventing biased advisory and promoting an alignment of interests between investors and advisors[159]. Here, we have a gap similar to the one seen in section IV.2.b) above, regarding the role of BSM's market-regulated MIC.

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157 Solidarity in liability as set by articles 7 and 34 of the Consumer Protection Code and article 932 of the Civil Code.

158 Pursuant to article 1, IV, of law nº 7.347/1985.

159 Tort law could perform a preventive role under the perspective that civil liability has a deterrent effect on convicted market players, who want to avoid further convictions, but this effect tends to be limited and indirect, especially in Brazil, where, differently from the United States, there is no statutory basis for punitive damages – although case-law occasionally recognises a punitive purpose in liability.

Another gap in the investor protection tools of tort law is the difficulty in producing evidence of both the advisor's misconduct and the harm suffered by the client. Due to the complexity of the securities market and, most of all, the difficulty in accessing information about the advisor's compensation conditions, demonstrating that the advisory service was biased and that it caused harm to the investor can be hard and costly in practice, legally, financially, and timely. For example, given the necessary expertise to demonstrate the incentives promoted by the advisor's compensation conditions and to verify the recommendations' suitability to the client's profile, claims against biased advisory can demand expert witness to support the plaintiff's pleas.

With the duty to disclose clear, concise and easily accessible information about the broker's remuneration proposed at the 2021 public hearing (*Audiência Pública SDM nº 05/2021*), as explained in section IV.2.a) above, discovery costs for investors could decrease, revealing a positive overlap between the regulatory and the private law frameworks. However, since the Reg. 178 did not include this proposed amendment in its final version, this remark goes no further than mere wishful thinking.

Regarding class actions specifically, where the MP and class-representation entities file on behalf of investors, discovery costs would not be a significant issue, considering the resources and expertise of these plaintiffs in court litigation, especially the MP. Even though, resorting to the MP or a class-representation entity might not always be the most desirable option for investors, since some might prefer to conduct their own lawsuit and avoid an even longer proceeding in court. Taking damage claims arising from misinformation as benchmark, research shows the ineffectiveness of class actions in investors' attempt to repair from harm[160].

An additional gap in tort law tools is the relative legal uncertainty in Brazilian courts' case-law. Due to the lack of a wide variety of judicial proceedings dealing with this issue and the inexistence of superior court rulings about this topic, there is no consolidated case-law in Brazil about the standard of proof and the liability conditions of investment advisors and their respective brokerage firms for biased advisory services. Although there is consolidated case-law about liability in general, the small quantity of cases dealing with biased investment advisory specifically can open the gates for diverging court deci-

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[160] Pursuant to research conducted by Prado (2016), only three collective claims were filed by the *Ministério Público* and two were filed by investor representation entities, concerning damages for misinformation in the securities market, but none of the claims resulted in repair granted to investors.

sions. The poor prediction arising from this relative legal uncertainty serves as a disincentive and a practical challenge for the use of tort law tools by investors. The same tends to apply to arbitration awards.

As initially mentioned, private law is not limited to tort law, given that market players execute agreements with force of law between themselves, reason why it is pertinent to investigate the tools provided by contract law to investors who interact with advisors.

## b. Contract law

In addition to the abovementioned statutory law governing liability, contract law adds two additional sources of law to investment advisory: agreements executed between advisors and investors and agreements executed between advisors and brokers.

Regarding the former, the hiring of investment advisors by investors implies the creation of rights and obligations between the parties. It is not possible to assert the nature of a contract in abstract, requiring a concrete analysis of a contract's clauses. However, assuming the obligations set in the Securities Commission's regulation, it is possible to, at least, conceive an investment advisory as a service provision contract.

Given the nature of advisory services – highly specialized services for clients who are subject to various market risks that go beyond the advisor's capacity to manage, such as stock price fluctuation –, advisors have a duty of care (*obrigação de meio*), not a duty of end-result (*obrigação de resultado*). If they were subject to end-result duties, their activity would be excessively burdensome and, thus, unfeasible.

However, even though they are not obligated to provide certain result to clients, the duty of care creates a duty of diligence to advisors, *i.e.*, a legitimate expectation from investors that their advisors will operate according to reasonable standards of adequacy in favour of clients' interests[161]. In this sense, although the mere risk of biased advisory due to conflicting payment incentives does not violate this duty, a biased act – *e.g.*, recommending investment products based on an excessively optimistic perspective and disregarding the client's profile – can configure a breach of contract. Here, it is worth remembering the discovery costs analysed in the previous section, since proving biased advisory as a breach of contract leads to the referred challenges of gathering evidence.

161 For the concept of duty of diligence in Brazilian law, see Cavalieri Filho (2010, p. 361).

As described in chapter II, the document review conducted for this book found only two agreements where investors were a party to it[162]. These were standard contracts of brokerage services, thus not involving advisors directly. According to this author's inquiry towards market players, investors that use advisory services usually do not execute a formal agreement with the advisor or the corresponding advisory firm. This practice occurs because (i) there is a general notion that there is no contractual link between both parties and (ii) brokers are seen as the meeting point between investors and advisors[163].

The two agreements which the author accessed had few and limited references to advisors, lacking any specification of rights and obligations applicable to them. Such absence is expected, considering that, usually, advisors are not parties to these types of contracts executed between brokers and investors.

Regarding the second type of agreement – those executed between brokers and advisors –, which have been analysed in chapter III, they provide core standards to investment advisory services, since these documents address conflict of interests. The contractual obligations and oversight mechanisms provided by these agreements turn them into the most valuable source of law to assert how the risk of conflict of interests is addressed in Brazil.

Brokers' agreements with advisors provide additional duties comparing to those set by the CMN's and the Securities Commission's regulation, especially when major brokerage firms are involved, meaning contract law exercises a supplementary role to the State-regulated framework. One can argue that this phenomenon is an effort by market players to fill in a gap of public law in addressing risk of advisors' conflict of interests. Just to illustrate the innovating nature of some of these agreements, a clause in the agreement executed between XP *Investimentos* and *Acqua Agente Autônomo de Investimentos* (a major broker and a major advisory firm in Brazil) obligates the advisory firm to anticipatedly report to the broker any attempt to enter the brokerage market or operate as an advisor under a competing broker[164].

This clause gives the "eye of the beholder" to the broker, placing it at a competitively strategic position in the market, since the advisor is contractually obligated to anticipate any attempt of competition, serving as an additional

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162 Standard agreements from *Bradesco S.A. Corretora de Títulos e Valores Mobiliários* and XP *Investimentos*.

163 According to this perspective, the fact that the advisor is a *longa manus* of the broker dismisses the need of a contract to be executed between the advisor and the client, who already executes a contract with the broker.

164 Clause 3.2.1. (u) of the agreements between XP *Investimentos* and *Acqua Agente Autônomo de Investimentos* and between XP *Investimentos* and *EuQueroInvestir* (EQI).

competition compass to the broker. Considering that this clause was only present in the agreements executed with major or emerging advisory firms (Acqua and EQI), one must conclude that the innovating obligations are tailored according to the advisor's importance in terms of brand value and invested amounts in advised clients' accounts.

The agreements between brokers and advisors address the possibility of biased advisory through different clauses, either directly or indirectly, and both implicitly and explicitly, by mentioning the term "conflict of interests".

As for clauses that address conflict of interests under a more direct way, many agreements attribute to advisors the obligation to "refrain from practices that may violate the fiduciary relationship maintained between the investors and the broker"[165]. As detailed in chapter III, biased advisory is, by definition, the subversion of an advisor's fiduciary duty, reason why this clause can be used to address this issue.

Moreover, many of these agreements contain a prohibition of advisors providing to investors recommendations that seek "undue advantage for the advisor or third parties"[166]. Considering that biased advisory is motivated by the advisor's pursuit to obtain undue advantage (*e.g.*, higher fees), recommendations in this sense can constitute a breach of contract under the transcribed clause – these advantages can be considered undue because they raise investors' agency costs or transaction costs, as explained in chapter III.

Some agreements also contain clauses that allow the brokerage firm to cancel the advisor's access to its operating systems and reject the execution of orders passed down by the advisor, in cases where the broker has legitimate suspicion that the advisor is operating unlawfully, as could be the case of biased advisory[167]. Such clauses allow brokers to act in upfront, preventing investor harm from biased advisory.

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165 The excerpt is the author's translation. This clause appeared in, *e.g.*, agreement between XP *Investimentos* and *Marcelo Galvão Morroni* AAI, clause 3.4.3, (b); agreement between XP *Investimentos* and *Confiança Agente Autônomo de Investimentos*, clause 3.2.2, (b); agreement between *Walpires* and *Soldi Agentes Autônomos de Investimentos*, clause 4.1, (k); agreement between XP *Investimentos* and *EuQueroInvestir* (EQI), clause 3.2.2, (b).

166 *E.g.*, agreement between XP *Investimentos* and *EuQueroInvestir* (EQI), clause 3.3, (e); agreement between BTG *Pactual* and *Porte Agente Autônomo de Investimentos*, clause 3.4, (i); agreement between *Walpires* and *Soldi Agentes Autônomos de Investimentos*, clause 5, (f); agreement between XP *Investimentos* and CDR *Agentes Autônomos de Investimentos*, clause 3.5, (e).

167 *E.g.*, agreement between XP *Investimentos* and *Ação Investimentos*, clause 3.6.; agreement between XP *Investimentos* and *Marcelo Galvão Morroni* AAI, clause 3.6.

As for clauses that address conflict of interests only indirectly, a common clause in these agreements is the obligation of advisors to execute their activities diligently, according to the standard of how "every diligent man" would act towards his own property and rights[168]. Naturally, if one can expect the advisor to operate as if the advisor's own property and rights were at stake, conflict of interests is incompatible with such standard of conduct and, thus, the client does not expect the advisory service to be biased.

Another obligation applicable to advisors is the duty to "provide information about the types of investments, especially those related to their risks"[169]. Given that omission or distorted information are ways to pursuit conflicting interests, this clause could be breached under a biased advisory service, therefore, serving as an indirect addressal to this issue.

Agreements from broker *BTG* in recent years have provided an additional duty to investment advisors, requiring them to submit to clients a term of consent of risks and a risk profile form before the start of the advisory services[170]. Such approach not only anticipated part of the novelty brought by Reg. 178, which requires the investor's previous acceptance to a term of consent about risks (Annex A to Reg. 178), but also reinforces the duty to suitability applicable to advisors.

The agreements executed with brokers also provide surveillance mechanisms over advisors' activities, such as the duty to present to the broker all documents about the execution of the advisory services, whenever the broker requires[171], and the duty for advisors to display broker's ombudsman's contact information in their merchandising material[172], thus, facilitating investors' attempts to file a complaint about a biased advisory service before the broker.

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168 *E.g.*, agreement between XP *Investimentos* and *Ação Investimentos*, clause 3.4.3.

169 *E.g.*, agreement between XP *Investimentos* and CDR *Agentes Autônomos de Investimentos*, clause 3.4.2, (i).

170 *E.g.*, agreement between *BTG Pactual* and *Porte Agente Autônomo de Investimentos*, clause 2.4.

171 *E.g.*, agreement between XP *Investimentos* and CDR *Agentes Autônomos de Investimentos*, clause 3.4.2.1; agreement between XP *Investimentos* and *EuQueroInvestir* (EQI), clause 3.2.1.1; agreement between XP *Investimentos* and *Confiança Agente Autônomo de Investimentos*, clause 3.2.1.1.

172 *E.g.*, agreement between XP *Investimentos* e *Ação Investimentos*, clause 3.4.2, (p); agreement between XP *Investimentos* and *Confiança Agente Autônomo de Investimentos*, clause 3.2.1, (o); agreement between XP *Investimentos* and *Marcelo Galvão Morroni* AAI, clause 3.4.2, (p); agreement between XP *Investimentos* and CDR *Agentes Autônomos de Investimentos*, clause 3.4.2, (p).

Similarly, agreements also require that advisors "attend to requests of the broker's Audit department under a 48-hour deadline or an alternative time length granted by the broker"[173]. This type of obligation demands advisors' promptness in attending to the requests of a corporate department that performs an important oversight role, thus, indirectly favouring a rapid response to an occasional biased advisory service.

These clauses exercise the role of gatekeeping and contractual oversight by expanding the broker's influence and surveillance over advisors, who are, by definition, an extension of brokers in the distribution and trading of investment products. In summary, there are numerous clauses that address the possibility of advisor's conflict of interests, either directly or indirectly.

In this context, formal complaints to the advisor's related brokerage firm are an investor protection tool in the contract law framework. However, this tool suffers from, at least, three gaps in effectively protecting investors and addressing biased advisory. Firstly, biased advisory is hard to spot by both the investor and the broker, as it can occur by the investor simply operating as recommended by the advisor, unaware of the conflict of interests, as detailed in chapter III. Conflict of interests is not always evident in documents and its proof can require more than a broker's mere request for clarification or document submission, as demonstrated by the discovery costs detailed in section IV.3.a). Thus, an investigative proceeding conducted by a broker's ombudsman, compliance or audit department can have little effect in the advisor's conflicting incentives.

The second gap to this investor protection tool is the risk of brokers being biased alongside advisors due to a conflicting interest of higher brokerage fees, doubling the investor's vulnerability. If the broker subverts its role of attending to the client's interests, in breach of article 31 of Resolution CVM nº 35/2021, the tool of complaint to the broker will be of no use to protect investors from a biased advisory service. In other words, contractual oversight mechanisms are useless if the oversight body suffers from the same conflict of interests that affects the overseen player (advisor), leading them to crony collusion.

The research underlying this book did not attempt to assert whether such risk effectively takes place in the Brazilian securities market, but, naturally, this risk

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173 *E.g.*, agreement between XP *Investimentos* and *Ação Investimentos*, clause 3.4.2, (j); agreement between XP *Investimentos* and *Acqua – Agente Autônomo de Investimentos Ltda.*, clause 3.2.1, (j).

should be considered when weighing investor protection tools and possible gaps, since the brokers and advisors are subject to similar incentives in regard to compensation conditions (see chapter III).

To conclude, the third gap of this investor protection tool is the poor information available to clients about brokers' oversight mechanisms over advisors. Since investors are not parties to these agreements and access to them is difficult, contract law provides little to investors and its effectiveness depends mostly on brokers' initiatives than on investors' own decisions. An investor protection tool that depends little on the investor him/herself tends to be of little use, unless the party in charge of it is active in protecting investors' interests.

Brokers' compliance policies, while applicable to advisors, are publicly available to investors, but their content is far more limited, shallow and generic in addressing conflict of interests than agreements executed between advisors and brokers. For this book, three compliance policies were analysed, namely, BTG's Guidelines of Procedures and Oversight for Investment Advisors ("*Manual de Procedimentos e Supervisão de* AAI"), XP *Investimentos*' compliance policy ("*Política de Compliance*") and *Órama* DTVM's Policy for Investment Advisors ("*Política para Agente Autônomo de Investimentos*").

*BTG*'s guidelines provide detailed rules about procedures and oversight applicable to advisors associated to this brokerage firm, such as the possibility of *in loco* visits from broker officers to the advisory firm and a list of documents that advisors must request from investors to verify their risk profile and define the standards of suitability.

XP's compliance policy, on the other hand, has a broader scope, regarding not only advisors, but, also, employees and third parties hired by the brokerage firm. Its form of addressing conflict of interests is overly broad, while focusing strictly on the perspective of the advisor's conflict of interests towards the broker, not the investor[174].

As for the third analysed document, *Órama*'s policy is brief and does not mention conflict of interests, although it provides various forms of monitoring and guiding advisors by different departments of the brokerage firm. The legal department provides a draft of the agreement to be signed by the broker and the advisor, in addition to verifying the adequacy of the documents provided by the advisor for the hiring[175]. The sales department conducts regular vis-

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[174] Item 3 of XP *Investimentos*' compliance policy ("*Política de Compliance*").

[175] Item 5.3 of *Órama* DTVM's Policy for Investment Advisors ("*Política para Agente Autônomo de Investimentos*").

its to the advisor's premises and oversees the advisory firm's compliance to clients[176]. The compliance department, in turn, investigates the advisors' background before official hiring and monitors the advisors' conducts through audits over transaction orders and operational risk management[177].

Even though these policies are publicly available, their content does not encompass all contractual duties and standards applicable to advisors, meanwhile the aforementioned difficulty in monitoring biased advisory and the risk of double conflict of interests. Addressing such conflict in compliance policies can be an effective way to mitigate the issue without courts and regulators, but, as it actually appears to be the case, these policies can end up as mere formal provisions that lack a direct and specific response, a problem widely debated in corporate governance and compliance literature (Viol, 2019, pp. 147-8). This is why they are insufficient to fill in the gap of contractual oversight mechanisms provided by broker agreements.

## 4. Intermediary conclusion

Brazilian law provides various tools of investor protection through its competition law, regulatory and private law frameworks. However, these tools suffer from gaps that hinder the attempt to provide an ideal protection to investors against the risk of biased advisory, leading to practical challenges that are not evident in the law in the books, only in the law in action.

The legal tools available to investors in Brazil have either a compensatory or a deterrent nature towards conflict of interests, failing to address biased advisory under a preventive approach. In addition to the lack of preventive legal tools, investors face challenges in the use of the existing tools also for their own purposes of compensation and deterrence. Therefore, the competition law, regulatory and private law regimes do not sufficiently attend either one of these three purposes of legal protection (compensation, deterrence and prevention).

These purposes are not fulfilled by the joint use of these tools, meaning an attempt to use all available tools will still implicate considerable costs to the investors and failure to address major causes of conflict of interests, which stand as blind spots in law. If Brazil had to be diagnosed in a range between under-

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[176] Item 5.3.5 of *Órama* DTVM's Policy for Investment Advisors ("*Política para Agente Autônomo de Investimentos*").

[177] Itens 5.2.1.6 of *Órama* DTVM's Policy for Investment Advisors ("*Política para Agente Autônomo de Investimentos*").

enforcement and overenforcement of investor protection, the gaps of the legal tools described above indicate that this jurisdiction is closer to a level of underenforcement rather than overenforcement.

When the law does not provide adequate tools to address a social issue, market players resort to other means, such as informal market practices. Not every situation needs the law as a solution. However, especially for retail investors and foreign investors, who tend to be outsiders of local practices, the law must fulfil its role of mitigating an investor's transaction costs or agency costs.

To systematize the legal tools and gaps analysed in this chapter, table 6 provides an overview of the main conclusions:

**Table 6 – Overview of the legal tools and gaps of investor protection in the legal regimes applicable to investment advisors**

| Legal framework | Applicable norms | Competent authority | Tools for investor protection | Gaps and limits |
|---|---|---|---|---|
| Competition law | Law nº 12.529/2011 | Competition authority (CADE) | Public enforcement – Complaint for the launching of an antitrust investigation for anticompetitive infringement<br><br>Private enforcement – Standalone lawsuit (for gaps and limits, see "Private law" below) | –Limited applicability due to dominance requirement (infringements by effect).<br>–Difficulty in establishing theory of harm concerning biased advisory and reaching standard of proof.<br>–Applicability limited to present, past, and imminent infringements. Fulfils mainly deterrent role, rather than prevention and repairment. |
| Regulatory | Regulation nº 178/2023<br>Regulation nº 11/20<br>Directive nº 617/19<br>Regulation nº 2.838/01<br>Law nº 6.385/1976 | Securities Commission (CVM)<br><br>National Monetary Council (CMN) | Complaint for the launching of an administrative proceeding for regulatory misconduct | **State-regulated framework**<br>–Lack of consolidated administrative case-law about sanctioning biased advisory services. |
| | Internal regulation of the Mechanism of Investors' Compensation | Stock Exchange (BM&F *Bovespa Supervisão de Mercados*) | Compensation request to the Mechanism of Investors' Compensation<br><br>Complaint for the launching of an administrative probe based on market regulation | **Market self-regulated framework**<br>–Compensation limited to BRL 200.000,00.<br>–Strictly compensatory purpose, lacking any preventive or deterrent role against biased advisory services. |

| | | | | |
|---|---|---|---|---|
| | | | | –High dismissal rate of investor requests.<br>–Low awareness of investors on the existence of the MIC or how to access it. |
| Private law | Law nº 10.406/ 2002<br>Law nº 8.078/ 1990<br>Law nº 7.347/ 1985 | National courts<br><br>Public Prosecutor's Office (*Ministério Público*)<br><br>Arbitration (if applicable) | Lawsuit with request of specific performance (disclosure of advisor compensation conditions)<br><br>Lawsuit seeking personal damages<br><br>Class action lawsuit<br><br>Complaint to the brokerage firm's Ombudsman | **Tort law**<br>–Applicability limited to cases of investor damage or imminence of damage.<br>–High discovery costs to prove damage in court.<br>–Complexity in measuring the extent of damage.<br>–Relative legal uncertainty due to lack of consolidated caselaw in Brazilian courts.<br>–Lack of coherence or usefulness of consumer protection tools regarding flawed services to the advisor-investor context.<br>–Time taken by a court proceeding to reach its conclusion.<br>–Side-effect of diminishing the remaining level of trust and dialogue that may exist between the advisor and the investor, in case of an ongoing advisory service.<br>–In the class action front, the investor depends on legitimate plaintiffs for filing and pleas in court. |
| | | | | **Contract law**<br>–Biased advisory may not be easily verifiable, turning some obligations and contractual oversight mechanisms nearly useless.<br>–Risk of brokers being biased alongside advisors due to a conflicting interest of higher brokerage fees, doubling the investor's vulnerability.<br>–Investors are not part of broker/advisor agreements, meaning many existing contractual remedies are not legally accessible to them. |

Source: Author's creation

# V. Improvements to the legal tools of investor protection

This chapter provides some suggestions on how current investor protection tools can be improved to better address the risk of biased advisory services. Although these suggestions refer to the above case study on Brazil, it provides useful lessons for other jurisdictions. The law and its institutional framework are not the same in different jurisdictions, but, as anticipated in chapter I, conflict of interests is a human phenomenon, meaning the problem is mostly the same throughout the world. Cultural variations may play a role, but the human responses to incentives tend to be similar.

As anticipated in chapter I, the 2022 ESMA report, in Europe, adopts a limited perspective of biased advisory, attributing most of its risk to the ties an advisor may have with third parties, such as issuers. Since, as presented in chapter III, conflict of interests is a multifactorial problem, focusing on ties with third parties oversimplifies the issue and risks making the law ineffective to protect investors. The 2023 regulatory reform in Brazil took an important step towards addressing other sources of conflict of interests, such as rebate fees, but it still lost the opportunity to fill in important gaps.

As the list of suggestions below reveals, the recommended improvements complement one another, meaning there is no "silver bullet" or one-size-fits-all solution to address the risk of biased advisory. The proposed legal measures have different levels of intervention in advisors' freedom of enterprise and involve different types of strategies, ranging from fostering certain types of conducts to normative amendments and enhanced oversight mechanisms.

However, most of the proposed measures have a soft approach, *i.e.*, minimal intervention. State measures can play an important role in mitigating agent misconducts through sanctions and reducing transaction costs through supplementary rules that dispense interparty negotiation, but, naturally, these measures bear the risk of either underenforcement or overenforcement, producing adverse effects to private parties (Macey & Miller, 1997, p. 82). Thus, needless to say that any intervention should be carefully planned and implemented.

Moreover, although agency theory provides an approach according to which the law has the purpose of reducing agency costs by imposing fiduciary duties to the agent (Sitkoff, 2014, p. 43; Bhattacharya *et al.*, 2019, p. 1), the measures proposed herein adopt a wider perspective about the role of law. To avoid overenforcement – *i.e.*, turning investment advisory overly burdensome –, the

list of recommended improvements does not focus on convicting biased advisors, but, rather, on strengthening the demand side (retail investors) and favouring alignment of interests.

To provide a useful and realistic approach to the proposed measures, the list below is separated between short/medium-term and long-term recommendations, given their different ranges and expected outcomes. The measures are detailed below:

**Short/medium-term recommendations**

- In the CVM's regulation, specify, under a non-exhaustive form, the duties of advisors toward investors and explicit the prevalence of investor interests in comparison to other market participants.
- Provide a mandatory requirement where large advisory firms must have an independent suitability analysis unit, whose outputs must guide advisors' recommendations to clients.
- Create a duty to adequately reason investment recommendations for advisors, to show in clients' monthly receipts.

**Long-term recommendations**

- Enact norms of fostering financial education among retail investors.
- Intensify and restructure Ancord's Programme of Continuous Education by focusing on conflict of interests and involving other stakeholders in the programme.

The **first recommendation** is the non-exhaustive specification of advisors' duties toward investors and remark that investor interests should be upheld in cases where another market participant's interest is at conflict. This proposed measure is purely normative, in the sense that its implementation implies "only" the amendment of existing regulation – *e.g.*, adding an article to the current Reg. 178. Readers unfamiliar with legal disputes might have the impression that a normative amendment to statutory law is, in itself, of little practical implication. However, the way the law is written can crucially change the outcome of legal debates and court interpretation. In other words, sometimes what is obvious must be spelled in legal text.

This recommendation aims to facilitate the legal definition of biased advisory cases as regulatory misconduct, given that current legal provisions, though sufficient, are quite open in relation to how advisors must balance investor interests with the interests of other market participants, such as the broker's, as

explained in chapter III. It is worth noting that the recommendation concerns non-exhaustive specification of advisor duties, meaning CVM commissioners will still have wide discretion in adapting the law to various forms of misconduct based on legal interpretation.

In addition, this recommendation also aims to foster case-law formation at the Securities Commission, in order to mitigate legal uncertainty to those who resort to the regulator as safeguard. Moreover, the clarification of advisors' duties in the sector regulation can also facilitate the work of courts when addressing biased advisory cases, since Brazilin judges do not commonly have expertise in securities market issues[178]. By providing clear standards of conduct, a normative amendment can enhance court activity in this matter, along with occasional training programmes aimed for court members.

The necessity to enhance Brazilian judges' familiarity with investor protection cases can be noticed not only by practical experience, but, also, by the fact that, taking the State of São Paulo as an example, only disputes between brokers and advisors are submitted to specialised chambers, while disputes between investors and advisors or brokers tend to be allocated to non-specialised chambers in charge of general private law issues[179]. As remarked in chapter IV, taking investor protection cases to courts implicates significant level of legal uncertainty, which arises from, among other causes, the lack of familiarity of Brazilian judges with investor protection cases, notwithstanding the high expertise of Brazil's Judiciary in other topics and the extremely demanding public tender to which judges are subjected before taking office.

The **second recommendation** for investor protection improvement is the mandatory requirement of an independent suitability analysis unit, whose outputs must guide advisors' recommendations to clients, for large advisory firms. Requiring such department could both promote a closer suitability oversight to advisors' recommendations and avoid an additional burden on brokers, who are an external party in relation to the advisory firm and may also suffer from conflict of interests.

To avoid excessive regulatory costs to medium or small firms or raising barriers to entry in the investment advisory market, this requirement could be applicable only to large firms, who, in turn, could be defined as such based in cri-

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[178] This problem has been previously identified in a study conducted by Prado (2016, pp. 44, 49), which stated the lack of specialization of Brazilian courts as an obstacle to damages claims by investors.

[179] In the São Paulo court, case distribution is governed by Resolutions TJ nº 538/2011 and 623/2013.

teria of annual revenues or clients' invested amounts. In addition, large firms who would have to comply with this requirement would have an initial transition period to adapt to this new requirement.

Under this model of operation, the advisor would have less autonomy in recommending transactions and investment products to clients, due to the need of complying with the suitability unit's directives. The advisory service would work in the following way: the investor provides information about his risk profile to the advisory firm and this information is internally forwarded to the suitability unit, after the investor's consent and complying with data protection laws. The members of the suitability unit jointly define the directives for the investor's account based on individual suitability. These directives can encompass identifying products that can or cannot integrate the client's account, along with limits per product (*e.g.*, certain product cannot correspond to more than 30% of the client's account).

These directives would limit advisors, but they would provide room for advisors to shape the suitability standards based on their own expertise and the objectives of the client. In other words, the suitability directives would not entrench the advisor's activities, despite limiting them. In this proposed measure, in case of failure to comply with the independent unit's directives, the advisor may be investigated by the advisory firm's or the broker's compliance department.

This proposed measure would only work adequately if (i) the suitability unit is independent, *i.e.*, advisors and brokers do not influence its members – this includes not being paid on variable-commission-based compensation –, (ii) clients have sufficient access to the unit's work under transparency conditions, and (iii) advisors have some level of discretion to operate under the suitability directives. If these conditions are met, it is expected that advisor's and investor's interests are predominantly aligned, while advisory services tend to be customized to the client's individual needs[180].

The **third recommendation** is the creation of a duty to adequately reason investment recommendations for advisors, to be shown in clients' monthly investment receipts. This reasoning should demonstrate that advisor took the client's individual suitability in consideration. By requiring that advisors reason their recommendations in a formal way, the law would probably mitigate in-

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[180] This recommendation resulted from a joint reflection between the author and Professor Otávio Yazbek during the final public defence of the master's dissertation in which this book is based, in 2022.

formation asymmetry between advisors and investors, promote transparency in advisory services and induce advisors to value the client's individual suitability, thus, reducing the client's costs in monitoring the advisor.

Considering the fast-paced aspect of the securities market and advisory services alike, this duty should be adequately shaped by the Securities Commission to avoid an entrenchment of advisor's activities. It is important that the sector regulator, who has more expertise in the regulated market, shapes regulatory duties based on the peculiarities of the market and its players, for example, through asymmetric regulation – *i.e.*, adopting different standards toward regulated players. While the reasoning must be in written form and through easily accessible language for any ordinary investor, it should not be too extensive and it should not be provided daily, otherwise advisors would have a heavy burden to their daily routine and investors would probably not even read these notes.

If the second recommendation proposed above were in practice, the advisor of a large firm could be exempt from attending to this third recommendation, given that compliance with the independent unit's directives would already attend to suitability. Otherwise, requiring the advisor to formally reason its advice in that condition would simply double the effort and bureaucratise advisory services.

This measure could have various benefits. While it could contribute to an *ex ante* control of advisory services, it incentives the advisor to value client suitability (even if only unconsciously) and, thus, promotes alignment of interests, avoiding litigation. Promoting alignment of interests should be a major goal of public policy, since investors face high costs in litigating with service providers (see chapter IV). In addition, the lack of concise reasoning by the advisor can serve as circumstantial evidence for biased advisory, so, even if this measure does not fulfil its purpose of aligning interests, it could reduce litigation costs by reducing discovery costs, which are one of the main challenges that investors face in Brazil (see chapter IV).

The **fourth recommendation** has a rather slower range of producing expected effects. It consists of enacting norms of fostering financial education among investors, which is fragile in Brazil, as mentioned in chapter II. Specifically, such norms could include federal laws for tax reduction to institutions that teach or sponsor financial education initiatives, and implementing mandatory

financial education courses in public schools' curriculum. Different from the others referred above, this recommendation is typical for a developing country like Brazil, which has low ratings of basic education[181].

A culture of widespread financial education can provide a minimum level of investment expertise to retail investors, who would have greater conditions to choose good advisors – *i.e.*, a solution for adverse selection and information asymmetry – and greater capacity to identify biased advisory. Additionally, a more educated pool of investors raises the risk of misconduct uncovering, reducing service providers' biased incentives. Investors with better expertise in financial issues and the functioning of the securities market tend to have better knowledge to access investor protection tools, such as complaints to the Securities Commission and compensation requests before the MIC, which is one of the gaps of the market-regulated framework (see chapter IV).

Finally, the **fifth recommendation** is to intensify and restructure Ancord's Programme of Continuous Education by focusing on conflict of interests and involving other stakeholders in the programme. As determined by the Securities Commission[182], advisors must attend to continuous educational programmes provided by certifying bodies (currently, Ancord) for update and technical enhancement purposes, in order to keep their certification active.

The programme which advisors must attend to is Ancord's Programme of Continuous Education (*Programa de Educação Continuada*, "PEC" for its Portuguese acronym), whose own regulation determines that advisors must renew their credentials every five years by enrolling in courses and conferences, and passing the programme's exams[183].

According to a founding partner of a major advisory firm (Favoretto Rocha, 2022, p. 119), the PEC lacks effective influence in advisors' activities because it is commonly attended to as a mere formality for certification renewal purposes. By analysing the PEC's regulation, no reference to conflict of interests or biased advisory can be found, although it requires advisors to attend to a minimum portion of courses focused on ethics, conduct, compliance, money laundering prevention and related topics[184].

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181 See, *e.g.*, <https://www.bbc.com/portuguese/articles/cv2zx819rg4o> and <https://www.cnnbrasil.com.br/nacional/educacao-brasileira-esta-em-ultimo-lugar-em-ranking-de-competitividade/>

182 Article 39, II, of Reg. 178.

183 Programme regulation available in: <https://www.ancord.org.br/wp-content/uploads/2023/03/Novo-Regulamento-PEC.pdf> Access on: 06/12/2023.

184 Programme regulation, item 2.2.

Naturally, courses and exams are no vaccines against misconducts, possibly having a discreet impact on professionals. However, a greater focus on the risk of conflict of interests, the fostering of best practices of transparency, and an incentive to personal reputation as a key professional trait are ways to enhance the positive effects of the PEC. Promoting awareness of the risk of biased advisory is an additional way of mitigating the risk of this practice in the securities market.

Finding the right dose to solve conflict of interests demands, first and foremost, understanding its causes. Given that conflict of interests is a risk resulting from various factors of incentives (see chapter III), biased advisory does not necessarily involve an evil mastermind behind a desk. Although it may, biased advisory can also result from spontaneous and unconscious decisions from advisors that are trained or incentivised to pursue higher firm revenues. The corporate world is commonly moved by automated thinking. Thus, awareness among advisors themselves can help prevent conflict of interests.

To conclude, for better chances of effective reflection upon conflict of interests and to avoid corporative effects in the PEC, involving various stakeholders in the programme could be a useful strategy. Stakeholders include investors, issuers, civil servants of the Securities Commission, the competition agency, the CMN and the Central Bank, attorneys, scholars, among others.

In summary, these five recommendations have the potential to jointly mitigate the risk of conflict of interests in the market, even if this risk will always exist in some level – as labelled in chapter I, conflict of interests could be an intrinsic human problem. This is where genAI comes as a potential game-changer.

## VI. The roles of generative AI in biased advisory

There is nothing new in machines influencing human decisions. This has been the case for centuries, since humans started using machines as tools; from navigation tools and radio transmitters to traffics lights and domestic artificial intelligent assistants. What changed over the years was the intensity with which such influence took place. The use of genAI for investment advisory illustrates this: the complexity required and autonomy with which genAI products can advise investors are significantly higher than traditional forms of machine-to-human relationships.

Determining an individual's risk profile – at least in good quality – demands deep understanding of human behaviour, while matching potentially suitable investment products demands some prediction of the future and mapping of

relevant conditions about the product, such as return rate, warranty requirements, and grace period. This puts automated investment advisory into an advanced class of "machines".

GenAI adds a layer of complexity to the legal challenges presented in the previous chapters: to the extent that genAI operates in a reasonably autonomous manner, the use of this tool almost equates to the inclusion of a new player in the supply chain of investment advisory services. More than that, it is a non-human player, meaning it tends to react differently to biased incentives, if compared to (human) advisors. Therefore, the nature of the risk of conflict of interests can change (from human to non-human). To current date of writing, genAI and other advanced technological tools are being widely used by market players in the financial services industry (CFA, 2022; Finra, 2020; WEF & Cambridge, 2020), but its effects to investor protection are still being studied.

Before diving into these effects and the legal challenges faced to address them, it is first important to classify different types of use of genAI for investment advisory. GenAI can be used for different tasks, namely, analysing the market, profiling the client (investor) according to his/her personal investment preferences (suitability), and/or providing investment recommendations. The role or extent to which the genAI tool serves as an advisor depends on how it is used by the broker or the investment advisory firm.

There are softer approaches in which genAI serves as an auxiliary tool. It may be used as a source of "second opinion" on advisory outputs or to perform only part of the intellectual process of providing an investment advice (*e.g.*, profiling the client under suitability terms). In both scenarios, genAI tends to produce significant influence in the final output, but there still remains space for purely human behaviour.

A more radical use of genAI products is the case of genAI serving as an advisor in all relevant stages of the intellectual process and humans (either advisors or brokers) serving as mere supervisors. Current AI deployment in the financial industry suggests that market players intend to mix roles between humans and AI products instead of simply substituting humans, meaning advisors tend to have a vertical (supply-like) relationship with genAI products instead of a horizontal one (competitor-like).

An example of this type of use would be the advisor or broker who asks a chat-bot what it the best investment for a certain client, leaving all relevant decisions to the genAI and evaluating if the bot's advice is plausible before forwarding it to the client. Nonetheless, genAI products can be used au-

tonomously by clients, possibly without the knowledge of the broker, such as the investor who asks investment questions to a chat-bot – commonly known as a robo-advising platform – and invests accordingly[185].

In summary, genAI can play different roles in investment advisory and, therefore, influencing investor decisions. The more radical the use of genAI to fulfil the tasks of advisory, the more it tends to change the effects of incentives over biased advisory. Considering the causes of conflict of interests presented in chapter III, genAI poses potential benefits and risks to investor protection. To understand these benefits and risks, a case-specific assessment of the individual characteristics of the genAI product should be conducted, but general assumptions can be taken from the known functioning of these technologies.

In terms of potential benefits, the data processing capability of genAI products can enhance the quality of investment advisory services through, *e.g.*, a quicker and more detailed overview of the products available in the market and their risks, as well as enhanced precision in the suitability assessment of clients. The outcome tends to be a better match between the products offered by the broker and the client's individual suitability, mitigating unsuitable advice resulting from advisors' underperformance. A more tailored or "personalised" service is, in theory, better service. Furthermore, genAI products can serve as an alternative source of advisory, empowering investors to autonomously identify flawed advisory services.

Another benefit can be the prevalence of investor interests, depending on the genAI's algorithms[186]. The logic behind biased advisory is favouring the interests of the advisor or third parties in detriment of the investor's interests. If the genAI product is structured in a way that investor interests are clearly stablished and classified as its top goal in its algorithms, acting according to the advisory firm's or the broker's interests will only be possible if those interests do not conflict with the investor's. At least in theory, genAI products are more controllable than human advisors in balancing occasionally conflicting incentives, such as higher rebate fees and client satisfaction.

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[185] This would be the case of what Duffy and Parrish (2021, p. 5) describe as "pure robo-advisors", in contrast with the hybrid robo-advisor model, in which the investment advice involves some form of human interaction between an advisor and a client.

[186] By algorithms, this book adopts the concept used by the U.S. Financial Industry Regulatory Authority – Finra (2020, p. 4): "An algorithm is a set of well-defined, step-by-step instructions for a machine to solve a specific problem and generate an output using a set of input data".

However, at least at the current date of writing, where AI products are rapidly changing, understanding what integrates a genAI's algorithms and predicting its outcomes are extremely difficult tasks. This is the borderline zone between benefits and risks of genAI where investor harm can arise. A perhaps more philosophical question that can help understand the risk is: are genAI products more reliable than human advisors (and brokers)? Can genAI developers anticipate all occasions in which investor interests may conflict with those of the players who are deploying the AI product?

While genAI products are not subject to human emotions, meaning they tend to be less subject to wealth aspirations and the goal-gradient effect[187], genAI products with non-transparent algorithms pose the risk of being used as an instrument for biased advisors or investment platforms, as well as self-awareness, wherein the genAI product could favour itself over investors. Once genAI tools serve a greater purpose in investment advisory, dark patterns could easily nudge investor behaviour in detriment of investor protection.

Regardless of the cause (an ill-intentioned human behind it or simply the genAI itself), if genAI products suffer from biases, its potential reach is far greater than a biased individual advisor or even an advisory firm, due to the genAI's timely capacity to process and produce data[188]. An example of such potential harm is a genAI that submits a biased advice to multiple clients through their investment mobile app or major investment platforms that rely on a same biased AI provider to provide advisory services[189]. The effects, therefore, could shift from an individual basis to an economic crisis, as claimed by a U.S. authority[190].

Authorities can address these risks of biased advisory associated with genAI indirectly, through cross-sector AI regulation – *e.g.*, the EU AI Act and the U.S. Executive Order on the safe, secure, and trustworthy development and use of AI –, or directly, through sector-specific regulation. In the latter case, securi-

187 For more on the goal-gradient effect, see section III.3 (chapter III).

188 As remarked by the U.S. Securities and Exchange Commission - SEC (2023, p. 1), "Due to the scalability of these technologies and the potential for firms to reach a broad audience at a rapid speed, any resulting conflicts of interest could cause harm to investors in a more pronounced fashion and on a broader scale than previously possible".

189 These are all risks from the perspective of investors, but brokers and advisors themselves face risks from the use of genAI, ranging from liability issues to collusion.

190 Statement provided by chair of the SEC, Gary Gensler. See in <https://fortune.com/2023/08/07/sec-chairman-gary-gensler-ai-financial-crisis-herding-investing-trading/>

ties regulators are beginning to plan their approach. Brazil is lagging behind in this topic and the pioneer in it is the U.S. Securities and Exchange Commission ("SEC"), which proposed a set of rules on July 2023[191].

The SEC's proposed rules go beyond ordinary conflict-of-interests rules, such as only demanding disclosure and consent, and require brokers and advisors to (i) "identify and eliminate, or neutralize the effect of," conflict of interests that may arise from the use of so-called PDA-like technologies (which is a broader concept than genAI), (ii) adopt and record written policies and procedures for the identification and addressal of such conflict of interests, and (iii) review the effectiveness of those policies and procedures at least annually.

The reaction from many regulated players was widespread critical against the proposal, with some stating that the requirements are arbitrary, impossible to comply with, and overburdensome (Hughes, 2023). The background debate resides on whether current legal standards of investor protection are sufficient to address the risks of biased advisory from high-tech tools. If the conclusion is that they are not sufficient, a regulatory update is necessary, based on which the debate follows to define the right approach, *e.g.*, what to require from market players, among others.

The most suitable answer may vary per jurisdiction, but any assessment should consider the law in action, not the law in the books. The standard of investor's best interest and the duty of loyalty are not new legal terms in securities regulation, nonetheless, the concerns of insufficient investor protection against biased advisory do not seem to go away. While, as demonstrated above, the expected effects of genAI investment advisory are dubious, consisting of a mix of benefits and risks, tuning the best regulatory approach is arguably utopian and a decision has to be taken towards risking either side of the law enforcement spectrum (underenforcement or overenforcement).

The market conditions presented in chapters II and III and the gaps seen in chapter IV indicate that the current scenario is unfavourable to investors. Adding a new layer in the investment advisory supply chain, through new technologies whose functioning is still underexplored, will certainly demand new initiatives from market regulators and stakeholders.

[191] Available in <https://www.sec.gov/files/rules/proposed/2023/34-97990.pdf>

## VII. Concluding remarks

A practical perception of life demonstrates that all lines of work have professionals of various types, some being good-willed and others, ill-intended. This is an intrinsic variation in the human nature, and the profession of investment advisory could not be any different, as assumed in this book. However, regardless of the philosophical question of whether humans can be good or evil, incentives play a role in the performance of advisors as economically rational agents, especially when surrounded by a corporate environment.

Although investment advisors have important roles in the securities market and can contribute to investors' wellbeing, they can be subject to multiple factors that promote incentives potentially conflicting with investor interests. Based on a case study of the Brazilian securities market, where investment advisory has experienced an unprecedented rise along with the digitalisation of investment tools, this book found empirical evidence of incentives of conflicts of interests – incentives to favour itself or brokers in detriment of investors[192]. Being subject to conflicting incentives is not *per se* illegal and, if adequately addressed and informed, should not be a significant problem.

The starting point of these incentives is the advisors' position of serving two kings (investors and brokers), where they are subject to the following conditions: (i) compensation conditions according to which the advisor's fee is higher based on specific investment products and/or on client's account turnover, (ii) use of attractive goal-oriented standards to shape the advisor's incentives, (iii) poor transparency of the advisor's compensation conditions toward the investor, (iv) burdening fixed costs, and (v) lack of financial education by investors in general, weakening monitoring conditions and favouring adverse selection. Conflict of interests is, therefore, not due to a single cause, but, rather, a multivariable problem, serving as a key takeaway for jurisdictions that overconcentrate their efforts in one potential factor, such as the advisor's corporate ties as the main source of conflict of interests.

As empirically verified, regarding market practices of advisors' compensation conditions:

- Agreements between brokers and advisors usually provide duties or oversight mechanisms that address, either directly or indirectly, the possibility of the hired advisor's conflict of interests.

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192 Whether these incentives are indeed embraced by advisors or if biased advisory does take place in Brazil are questions this book did not aim to respond.

- The compensation conditions commonly adopted in the market is the rebate fee (variable-commission-based compensation) and the biggest gap of rebate fees takes place between quotas of different investment funds.
- Brokers usually adopt goal-oriented standards to shape advisors' incentives, offering attractive awards in case advisors reach certain goals, mainly concerning clients' investment amounts, but also revenue goals, asset prospection goals and transaction goals (quantitative and/or qualitative).

The risk of conflict of interests, though not *per se* illegal, raises investors' surveillance costs and enhances the chances of investor harm. To address this risk or unlawful conducts thereof, the law provides investor protection tools through its competition law, regulatory and private law frameworks. However, even after a regulatory reform conducted in 2023, these tools have gaps of their own and, even if used jointly, fail to provide sufficient investor protection.

Specifically, in competition law, by framing biased incentives as abusive behaviour by investment platforms, the legal tools for investors are promoting public enforcement, through whistleblowing on anticompetitive infringements before the Brazilian competition agency (CADE), and promoting private enforcement, through standalone lawsuits in Brazilian courts with request of damages and/or specific performance.

In the regulatory framework, specifically in the State-regulated branch, investors can file a complaint before the Securities Commission for the launching of an administrative proceeding for regulatory misconduct. In the market-regulated branch, investors can seek compensation by filing a request to the Mechanism of Investors' Compensation governed by the stock exchange oversight board and file a complaint for the launching of an administrative probe based on market regulation.

In the private law realm, investors can individually file a lawsuit before Brazilian courts or a court of arbitration (if applicable) with request of specific performance (disclosure of advisor compensation conditions) and/or personal damages. Alternatively, investors can also seek the Public Prosecutor's Office or a class-representation entity for the filing of a collective claim. In the contract law branch, investors can file a complaint before the brokerage firm's Ombudsman or the advisor's compliance department, for internal proceedings and corporate sanctions.

Despite these various tools, they fail to provide plain investor protection because they lack a preventive approach and, even in their intended roles of compensating investor harm and deterring misconduct, they underperform.

In competition law, to the extent potentially applicable to biased advisory, the tool of public enforcement tends to address only conduct of dominant players, limiting its applicability, and requires a difficult theory of harm and high standards of proof, due to the novelty of the approach and the chances of being qualified as a purely regulatory issue. In addition, the tool of public enforcement serves a predominantly deterrent purpose, while the tool of private enforcement faces the many challenges described in the private law framework.

In the State-regulated framework, the Securities Commission lacks a consolidated administrative case-law about sanctioning biased advisory services. As for the market-regulated framework, compensation is subject to a cap, the available tool before the MIC fulfils a strictly compensatory purpose, lacking any preventive or deterrent role against biased advisory services, there is high dismissal rate of investor requests, and low awareness of investors on the existence of the MIC or how to access it.

Concerning private law, the tools for civil liability also suffer from their own gaps, namely, applicability limited to cases of investor damage or imminence of damage, high discovery costs to prove damage in court, complexity in measuring the extent of damage, relative legal uncertainty due to the lack of consolidated case-law in Brazilian courts, lack of coherence or usefulness of consumer protection tools regarding flawed services to the advisor-investor context, time taken by a court proceeding to reach its conclusion, side-effect of diminishing the remaining level of trust and dialogue that may exist between the advisor and the investor, in case of an ongoing advisory service, and, in case of class actions, the investor depends on legitimate plaintiffs for filing and pleas in court.

In the contract law branch, tools may not be effective because biased advisory is hard to verify – the motivations of an advice are hardly explicit and the question on the most suitable product is hardly binary –, turning some obligations and contractual oversight mechanisms nearly useless, while there is a risk of brokers being biased alongside advisors due to a conflicting interest of higher brokerage fees. In addition, investors are not part of broker-advisor agreements, meaning many existing contractual remedies are not legally accessible to them.

There are possible ways to improve these investor protection tools and, hopefully, to serve as inspiration for reforms that intend to update their legal tools against biased advisory. Some possible measures include:

- In the CVM's regulation, specify, under a non-exhaustive form, the duties of advisors toward investors and explicit the prevalence of investor interests in comparison to other market participants (short/medium-term measure).
- Provide a mandatory requirement where large advisory firms must have an independent suitability analysis unit, whose outputs must guide advisors' recommendations to clients (short/medium-term measure).
- Create a duty to adequately reason investment recommendations for advisors, to show in clients' monthly receipts (short/medium-term measure).
- Enact norms of fostering financial education among investors (long-term measure).
- Intensify and restructure Ancord's Programme of Continuous Education by focusing on conflict of interests and involving other stakeholders in the programme (long-term measure).

However, every legal innovation in view of mitigating risks of biased advisory and enhancing investor protection must consider the changes currently promoted by genAI products. These technologies can, on one hand, favour investor interests by serving as alternative sources of advisory and, thereby, empowering investors to identify flawed advisory services. They can also enhance the quality of certain advisory services, by providing quicker and precise matching between investment products the client's individual suitability.

Furthermore, genAI products are not subject to human emotions, meaning they tend to be less subject to wealth aspirations and the goal-gradient effect. In addition, genAI products are more controllable than human advisors in balancing occasionally conflicting incentives, so, depending on the genAI's algorithms, investor interests can be designed as prevalent.

On the other hand, genAI products can aggravate the risks of conflict of interests. Their potential reach is far greater than human advisors, due to their capacity to process and produce data in greater volume and in a faster manner. Understanding the functioning of algorithms of genAI products is key and participation of data scientists in policymaking is key for an effective multidisciplinary approach.

In summary, conflict of interests is a natural human phenomenon in society, but, in some circumstances, it has the potential to cause grave harm to those who trust the conflicted agent. With the rise of digital investment platforms

and genAI products for investment advisory, what was once a purely human phenomenon grew to become a potentially non-human phenomenon as well, with new shapes.

In the securities market, where rules and practices must be ultimately aimed at protecting investors from market failures, the risk of biased advisory must be subject to greater attention from all of its participants. In the case of Brazil, the law can play a more active role by strengthening investors through legal protection tools. In this scenario, there are no heroes or foes. A structural improvement will depend on a collective effort to shed light on the black holes of market practices and debate new measures after the 2023 regulatory reform. The academia can also play a role in this debate in, *e.g.*, behavioural economics in the context of automated advisory services, regulation of robo-advisors, research on the effects of new foreign direct investments (FDI) regulations in investment advisory services, among others.

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