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The Paradox of Financial Services Regulation: Preserving Client Expectations of Loyalty in an Industry Rife with Conflicts of Interest

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The Paradox of Financial Services Regulation: Preserving Client Expectations of Loyalty in an Industry Rife with Conflicts of Interest

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Abstract

This paper considers the implications of *Australian Securities and Investments Commission* v. *Citigroup* [2007] FCA 963, a landmark decision of the Federal Court of Australia. The case highlights an apparent paradox in financial services regulation: at the same time as allowing, or even fostering, the development of financial services conglomerates, regulation in multiple jurisdictions preserves potentially incompatible general law obligations that arise from client expectations of loyalty. The paradox is most evident in the context of the modern investment bank.

The paper discusses the dynamic nature of investment banks, their organizational structure, the types of conflicts they typically face and recent trends in the industry. It also considers a number of questions about the regulation of conflicts of interest at these firms. First, when an investment bank performs one of its traditional functions, what fiduciary constraints is it likely to face? Second, to what extent will the classic formulation of fiduciary obligations take account of both the conglomerate structure of the modern investment bank and the co-existence of legislation that regulates conflicts of interest? Finally, quite apart from the fiduciary obligation, what does – and should – a statutory obligation to "manage" conflicts of interest require? These questions are considered against the backdrop of *ASIC v Citigroup*.

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I. Introduction

The recent landmark decision of the Federal Court of Australia *Australian Securities and Investments Commission* v. *Citigroup*[1] has highlighted an apparent paradox in financial services regulation: at the same time as allowing (or even fostering) the development of the financial services conglomerate, regulation preserves potentially incompatible general law obligations that arise from client expectations of loyalty. The paradox is most evident in the context of the modern investment bank, which is itself a financial services conglomerate. When an investment bank performs one of its traditional functions – underwriting securities offerings or providing financial advisory services to clients involved in mergers, acquisitions and other strategic transactions – it may under general law be a fiduciary of its client and thereby be required to avoid positions of conflict without its client's informed consent. Yet the conglomerate structure of the firm may make conflicts of interest an inescapable feature of its doing business.

This regulatory tension is further complicated in some jurisdictions by legislation that imposes on investment banks obligations concerning conflicts of interest separate from those imposed under general law. In Australia, for example, many investment banks are subject to the statutory obligation to "manage" conflicts of interest, in addition to any fiduciary obligations they might owe. The different content and scope of the obligations gives rise to difficult questions about the regulation of conflicts in the industry.

This essay discusses the dynamic nature of investment banks, their organizational structure, the types of conflicts they typically face and recent trends in the industry. It also considers a number of questions about the regulation of conflicts of interest at these firms. First, when an investment bank performs one of its traditional activities, what fiduciary constraints is it likely to face?

[1] *Australian Securities and Investments Commission* v. *Citigroup Global Markets Australia (No 4)* [2007] F.C.A. 963 (28 June 2007). The case is referred to below as *ASIC v Citigroup*.

Second, to what extent will the classic formulation of fiduciary obligations take account of both the conglomerate structure of the modern investment bank and the co-existence of legislation that regulates conflicts of interest? Finally, quite apart from the fiduciary obligation, what does – and should – a statutory obligation to "manage" conflicts of interest require? These questions are considered against the backdrop of *ASIC v Citigroup*.

The significance of these questions is underscored by uncertainty surrounding the propriety of investment banking conduct. As recent transactions demonstrate, investment banks and their clients adopt a range of responses to apparent conflicts of interest. In the 2005 merger of the New York Stock Exchange and Archipelago Holdings, Inc in the United States, both companies consented to being advised by a single investment bank, which also held a stake in both companies. The bank's dual roles attracted sharp investor criticism.[2] In the management buyout of Kinder Morgan Inc in 2006, then the largest ever MBO transaction, the buyout consortium consented to the same investment bank simultaneously investing in, lending to and advising the consortium – conduct that embroiled the investment bank in litigation.[3] It is noteworthy that in the lead-up to the buyout the bank had advised the target company on the merits of such a transaction and had then introduced its buyout arm to the target's management to facilitate the deal.[4] In contrast, the London Stock Exchange plc is reported to have objected to its broker, an investment bank, representing Nasdaq Stock Market Inc in the Nasdaq's proposed bid for the LSE. This reportedly prompted the investment bank to withdraw from its takeover role.[5]

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[2] See *Higgins* v. *New York Stock Exch.*, Inc. 10 Misc.3d 257 (2005).
[3] See Neil Weinberg, "Goldman Sachs" World's most powerful investment bank", Forbes, January 17, 2007.
[4] See the (definitive) Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 for Kinder Morgan, Inc. (dated 17 November 2006, at 12-32, online at: http://www.sec.gov/Archives/edgar/data/54502/000104746906014243/a2174701zdefm14a.htm).
[5] J Anderson, "A Cold Shoulder in London Makes the Juices Run for Deal Financiers in New York", New York Times, March 14, 2006.

More recent examples demonstrate other apparent investment banking conflicts and client responses. Early in 2007, an Australian investment bank faced strident opposition from its former client, energy company Alinta Limited, over the investment bank simultaneously performing multiple apparently conflicting roles. While advising Alinta on a transaction, members of the investment bank allegedly held talks with the company's management about assisting with a management buyout of the company.[6] In the face of widespread media condemnation, the bank steadfastly defended the propriety of its conduct. The client's response, however, was to terminate the firm's advisory role. Criticism was directed at investment banks more recently in the battle for control of ABN Amro, a deal heralded as the largest ever in the financial services industry. While advising ABN Amro on its sale, some investment banks allegedly offered to help finance the offer by one of the consortia bidding for ABN Amro.[7]

These examples demonstrate variations in both investment banking conduct and client responses. In broad terms, the examples all involve a major investment bank performing the traditional investment banking role of providing financial advisory services to a client while simultaneously (and often using a separate arm of its business) performing another function apparently in tension with the interests of the client. Another feature of the transactions, at least from the perspective of the observer, was confusion – among investors, in the financial media, and perhaps also at investment banks – as to the propriety or otherwise of the investment banking conduct involved. In the NYSE merger, for example, was the investment bank compromising the interests of the NYSE by also advising the opposite side of the deal? In Kinder Morgan, could the investment

[6] Brian Frith, "Macquarie Bank should watch where it treads", The Australian, January 10, 2007, 17.
[7] See, Lucy Farndon, "Secret Documents Suggest RBS Has Money To Go Dutch" Daily Mail, May 15, 2007 (the bidding consortium, led by Royal Bank of Scotland, wrote in a letter dated May 3, 2007 to ABN Amro that RBS's financial advisers "have received numerous approaches from other major financial institutions, including some institutions currently advising you, wishing to participate in any fund raising we may do [for the proposed takeover]."). See also "UBS play both sides on ABN? – Judgement delay damage" Banking Newslink (www.bankingnewslink.com/factiva), May 15, 2007 (commenting that this conduct by advisors to ABN Amro "is bound to ignite once again all of the concerns and arguments over conflicts of interest amongst the global investment banks.")

bank properly participate in a deal to purchase its client? While fact specific, the legal answers to these questions require one to examine the nature of investment banks, their relationships with clients, the obligations – fiduciary and statutory – that arise, and how these obligations apply and interrelate in an industry apparently rife with conflicts of interest.

II. The nature of investment banks

A. Structure and designation

The term *investment bank* is widely, and loosely, used to describe a broad spectrum of organizations that participate in financial market transactions. The term is not a legal designation, but is applied to firms in the financial services industry that serve the needs of corporate management and governments. They use the financial acumen and expertise of their personnel to raise finance and restructure and combine corporations, among a broad range of activities. These firms offer a broad – and ever-changing – array of financial products and services to a deep client base in financial centers worldwide. Increasingly, firms are tending to deploy their own financial resources in transactions involving their clients and in doing so may act either as an agent of their client or as principal in the transaction.

Major investment banks typically adopt a conglomerate structure. Using separate divisions or business units, they perform their traditional functions – underwriting securities offerings and providing financial advisory services to corporate management.[8] In recent decades, firms have supplemented these activities with others, including securities and derivatives trading on behalf of clients, investment research,[9] financing, asset management, equities and derivatives trading on

[8] As to the traditional functions of investment banks, see, *eg*, Charles Geisst, *Investment Banking in the Financial System* (Englewood Cliffs, N.J., Prentice Hall, 1995) at p. 2; Alan D Morrison and William J Wilhelm, Jr, *Investment Banking: Institutions, Politics, and Law* (Oxford University Press, 2007) at pp. 21-25.

[9] Investment research involves providing fundamental research on companies, industries, economies, currencies, commodities and portfolio and quantitative strategy. See The Goldman Sachs Group, Inc Form

the firm's own account (also known as proprietary trading) and principal investing (such as private equity operations).[10] While broadly similar in terms of their product and service range and the capacities in which they act, major firms will differ in the relative emphasis they give to different business units and the operational autonomy with which each unit operates.

As well as diversifying their activities, investment banks have expanded across geographic boundaries and consolidated. Today the industry is dominated by a relatively small number of global firms with headquarters in either the United States or Europe. The organizational structure of firms may also be organized along geographic or regional lines as well as functional lines.

These changes have been driven by numerous factors. Client demand, forces of globalization and firms' desire to achieve economies of scale and scope have played roles.[11] A chief driver has been regulation – in many cases the deregulation of markets. Regulatory change in numerous jurisdictions has permitted, and even fostered, the development of the financial services conglomerate. In the United Kingdom, for example, legal reforms to the structure of the financial markets, including the abolition in October 1986 of the Stock Exchange's single capacity requirement that segregated broker and dealer functions, led many financial institutions to organize themselves as financial conglomerates.[12] In the United States, the repeal in 1999 by the Gramm-Leach Bliley Act of provisions of the Banking Act of 1933 that separated commercial

10-K (Annual Report) for the fiscal year ended 28 November 2003, filed with the Securities and Exchange Commission, at p. 12.

[10] See, *eg*, The Goldman Sachs Group, Inc Form 10-K (Annual Report) for the fiscal year ended 25 November 2005, filed with the Securities and Exchange Commission, at pp. 4-12; Morgan Stanley Form 10-K (Annual Report) for the fiscal year ended 30 November, 2005, at pp. 3-9; initiating process in proceedings in Federal Court of Australia between Australian Securities & Investments Commission and Citigroup Global Markets Australia Pty Ltd (NSD 651/ 2006); Andrew Tuch, "Investment Banks as Fiduciaries: Implications for Conflicts of Interest" (2005) 29 Melbourne University Law Review 478, at 486.

[11] For a discussion of the benefits of financial conglomeration, see, *eg*, Arthur E Wilmarth, "How Should We Respond to the Growing Risks of Financial Conglomerates" in Patricia A McCoy, *Financial Modernization After Gramm-Leach-Bliley*, (Lexis Publishing Co, 2002). (Available at SSRN: http://ssrn.com/abstract=291859).

[12] See Law Commission, United Kingdom, *Fiduciary Duties and Regulatory Rules: A Consultation Paper* (Consultation Paper 124, 1992) ("Fiduciary Duties and Regulatory Rules 1992 Paper"), at para. 1.1 and 6.7.

banking from investment banking has permitted financial institutions to engage in a full range of financial activities and has led to the breakdown of old distinctions among the different types of financial institutions.[13] Institutions that span the gamut of the financial sector evolved, engaging in consumer banking, investment banking, private equity investing and varied other activities. Japan’s own Big Bang is also said to have permitted different types of financial institutions to venture beyond their original boundaries.[14] In Australia, similar regulatory changes have made financial services conglomerates a feature of the institutional landscape.

Since this essay focuses on factors that may produce conflicts of interest and situations in which fiduciary relationships may arise, it is a firm’s organizational structure – rather than its underlying legal designation – that is most relevant. For example, it is more relevant whether a firm offers a full range of financial products and services, including performing the traditional investment banking roles, than whether it is organized in the United States as a securities firm or a bank holding company.[15] Though its legal designation will determine the regulations to which it is subject, that factor alone is unlikely to influence the likelihood with which conflicts of interest will arise or either the existence or content of any fiduciary obligations.

Investment banks also include firms that have, to varying extents, resisted adopting the conglomerate structure. Called independent or boutique investment banks, these firms typically specialize in providing financial advisory services to corporate management or governments. Prominent examples include the New York-based firms of Greenhill & Co and Lazard and the Australian firm Caliburn Partnership. However, some boutique firms engage in a limited range of

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[13] See Jonathan R Macey, Geoffrey P Miller and Richard S Carnell, *Banking Law and Regulation*, 3rd ed. (New York: Aspen Law and Business, 2001), at pp. 22, 33-35.
[14] See K Thomas Liaw, *The Business of Investment Banking: A Comprehensive Overview*, 2nd ed. (Hoboken, N.J.: John Wiley & Sons, 2006), at p. 4.
[15] As to the blurring of distinctions between these legal forms, see Jonathan R Macey, Geoffrey P Miller and Richard S Carnell, *Banking Law and Regulation*, *supra* note 13, at p. 35.

other activities, including principal investing and asset management, in addition to their core financial advisory role.[16] Not all boutique firms completely eschew the conglomerate structure.

In view of this industry description, it is misleading to suggest that all firms fall into one of two categories – conglomerate or boutique – depending on their organizational structure. Rather, firms should be regarded as falling along a spectrum or continuum in terms of their organizational characteristics.[17] The conglomerate or full-service firms will fall towards one end of the spectrum with the "pure" boutique firms towards the other end. Somewhere in between will lie the boutique firms that, while offering a narrow range of services, nevertheless have ventured beyond the traditional financial advisory role.

B. Incidence and classification of conflicts of interest

In broad terms, a conflict of interest arises where an investment bank is in the position where a conflict or overlap exists between the interests of (or a duty owed to) its client, on the one hand, and either its self-interest or the interests of another client, on the other hand. To put it another way, a conflict arises where, in a matter, an adviser has a personal interest or an inconsistent engagement with a third party or uses his or her position to self advantage or to advantage a third party.[18] The conglomerate organizational structure generates the potential for conflicts of interest to arise. The UK Law Commission has noted that this is primarily attributable to the range of products and services provided by a firm, the composition of its client base and the different capacities in which it conducts its business.[19] It has been said that conflicts of interest are an

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[16] See Andrew Tuch 'Investment Banking: Immediate Challenges and Future Directions' (2006) 20 (4) *Commercial Law Quarterly* 37, at pp. 38-39.
[17] This contrasts with the approach of some scholars. See, eg, K Thomas Liaw, *The Business of Investment Banking: A Comprehensive Overview*, *supra* note 14, at 12.
[18] See *Rawley Pty Ltd (ACN 009 027 454)* v. *Bell (No 2)* (26 April 2007) [2007] F.C.A. 583, at [261].
[19] Fiduciary Duties and Regulatory Rules 1992 Paper, *supra* note 12, at para. 2.2.1.

inevitable consequence of the conglomerate investment banking model and may even be inherent in it.[20]

As the analysis above demonstrates, it would be misleading to assert that a so-called boutique firm is conflict-free without a careful consideration of its organizational structure.[21] Conflicts may well arise within such a firm, even between its limited functions. Moreover, even for the "pure" boutiques – firms that provide a single service such as financial advisory services – the potential for conflict exists. Such a firm may well find itself on both sides of a deal, a rare but realistic scenario as illustrated by the NYSE – Archipelago merger described above. What can be said is that the investment banking industry is fertile ground for conflicts of interest.

Potential conflicts of interest at these firms involving their traditional activities may be classified in the following way.[22] First, a potential conflict may arise between an investment bank's self interest and the interests of its advisory or underwriting client. Examples include competing with a client for an investment opportunity (such as the purchase of a company or other assets) or being part of a syndicate doing the same; advising the bidder in a takeover while the bank's proprietary trading arm purchases shares of the target or its corporate banking arm lends to a competing bidder; advising the target in a takeover while the bank's asset management arm lightens its stock holding in the target;

[20] As to conflicts being inevitable or inescapable, see, *eg*, Royston Goode, *Conflicts of Interest in the Changing Financial* World (1986), at p xv; Fiduciary Duties and Regulatory Rules 1992 Paper, *supra* note 12, at para. 1.1, 2.2 and 3.1; Deborah A DeMott, *Fiduciary Obligation, Agency and Partnership: Duties in Ongoing Business Relationships* (1991), at p. 671, citing Herlihy, "Inside Trading and "Chinese Walls": Is There a Need for Reform" in Gary Lynch and Arthur Mathews (eds), *Securities Enforcement Institute* (1988) 441. As to conflicts being inherent, see, *eg.*, Malcolm Maiden, "When bankers collide", The Age, June 3, 2006.

[21] For example, in K Thomas Liaw, *The Business of Investment Banking: A Comprehensive Overview*, *supra* note 14, at 23, the author explains that a "boutique house" which provides both financial advisory services and engages in private equity investing "does not have any conflict of interests." This assertion as to the absence of conflicts is difficult to justify. While internal policies may minimize the possibility of conflicts, they remain possible. The provision by a firm, whether described as boutique of not, of multiple products and services creates the possibility of conflict, as the examples in Part I illustrate. Moreover, where the firm acts as a principal in transactions – as the firm does in private equity investing – the possibility of the firm's self interest conflicting with the interests of, or a duty owed to, a client is magnified.

[22] My thanks to Professor DeMott for suggesting the general classification of investment banking conflicts of interest that follows. All examples are the author's.

and underwriting a securities offering of a company that will use the funds raised to repay an existing loan to the investment bank.[23]

Second, a potential conflict may arise between the interests of one client and those of another client. Examples include advising separate clients considering the same investment opportunity; advising the target of a takeover offer while participating in a syndicate raising finance for the bidder; and while underwriting an issuer's securities offering, advising another party proposing to acquire the issuer.

Third, potential conflicts may arise among functions or services provided by an investment bank such that there is a systematic incompatibility between the interests being served. A well-known example of this is the provision by investment banks to brokerage clients of "independent" research reports (sell-side research) about companies to which banks desire to provide (highly remunerative) financial advisory and underwriting services. Another example is the practice of investment banks that have been retained to advise on a proposed takeover engaging in proprietary trading in the shares of either or both of the bidder and target companies before the deal is announced.[24] This practice aroused the ire of ASIC in *ASIC v Citigroup*[25] and is discussed below.

C. Market forces and recent trends

Investment banks are dynamic organizations. Their business mix shifts in response to financial innovations (such as the development of new products or markets) and changing market

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[23] A conflict will be more pronounced in this context where the bank's loan exposure is considered poor quality. See the comments of Knox J's in *Cowan de Groot Properties Ltd* v. *Eagle Trust plc* [1991] B.C.L.C. 1045, at 1116 (observing that where an underwriter advises a company to which it has previously loaned money, without more, difficulties arise with asserting the existence of a position of conflict).

[24] The risk of insider trading arises in this scenario since an investment bank advising on a deal prior to the deal's public announcement has within its possession non-public, price-sensitive information. To avoid insider trading liability and to protect the confidential information, traders will operate behind Chinese walls – measures internal to the firm designed to prevent the flow of information within the organization.

[25] [2007] F.C.A. 963 (28 June 2007).

conditions (such as the plentiful supply of cheap credit). These factors create new opportunities for money-making and also change the relative profitability of existing lines of business. For example, in recent years the potential returns generated by proprietary trading and principal investing have increased, with many banks moving aggressively into these lines of business. Investment banks have built teams of traders to engage in proprietary trading. Morgan Stanley, for example, recently formed what it called an "all star" team of dozens of traders to trade exclusively on the firm's account.[26] Some firms also raised substantial buyout funds allowing them to invest as principal in private equity deals.[27] As publicly-listed firms, investment banks publicly announce their earnings results and this may explain the aggressive strategies they adopt.

In other areas, the business mix of financial conglomerates has also evolved. Some firms have tapped into the business of making "subprime" home loans to consumers with flawed credit histories by lending to – and even buying – mortgage companies that make these loans, as well as providing securitization and other services to them.[28] Many firms have formed prime-brokerage units to serve the needs of increasingly important hedge-fund clients,[29] as well as buying hedge-fund businesses themselves.[30] Some firms are building substantial real estate businesses,

[26] Roddy Boyd, "Morgan Super Traders Worry Hedge Funds", New York Post (Online edition), April 13, 2006 (according to Morgan Stanley, the arrangement was adopted in part in response to expressed concern from mutual and pension funds that he firm might be "putting [itself] first". It also acknowledged that its hedge fund clients "might have some concerns" about the firm now competing with them in this area).
[27] For further discussion of the involvement of investment banks in private equity, see Andrew Tuch "Obligations of Financial Advisers in Change-of-Control Transactions: Fiduciary and Other Questions" (2006) 24 Company and Securities Law Journal 488, at p. 511.
[28] See, *eg.*, Michael Hudson, "How Wall Street Stoked The Mortgage Meltdown: Lehman and Others Transformed the Market For Riskiest Borrowers", Wall Street Journal, June 27, 2007, A1, A10 (reporting that investment banks provided capital to "subprime" lenders, pooled the income streams for these loans into bonds, or mortgage-backed securities, a process referred to as securitization, and sometimes also purchased the lenders outright, becoming lenders directly to consumers). Many of these loans have fallen into default. See, *eg.*, Kate Kelly and Randall Smith, "Market Swoons As Bear Stearns Bolsters Finances", Wall Street Journal, August 3, 2007.
[29] See, *eg.*, "Share-cropping: Hard-hit equity traders are fighting back", The Economist, May 19, 2007, 15 (reporting that some hedge funds have "developed lucrative prime-brokerage relationships with a trio of investment banks that moved into the business early… [b]ut the profitability of the prime-brokerage business has attracted many other investment banks").
[30] Emma Trincal, "HFs Are Fueling the Private Equity Engine", May 30, 2007 (reporting on the purchase by Citigroup of hedge fund Old Lane).

spending billions of dollars buying properties around the globe. The business mix of conglomerate investment banks is likely to continue to adapt to financial innovations and changing market conditions.

These shifts in the business mix of investment banks have consequences for the potential conflicts of interest they face. As a general matter, new opportunities and incentives will arise for firms to promote self interest or prefer the interests of certain clients over others. As an example, at the turn of the 21st Century, when the traditional investment banking functions provided a powerful financial lure, many firms favored the interests of potential clients for these services over those of brokerage clients. The egregious conflicts of interest associated with research analyst reports disclosed by regulatory investigations, including those associated with New York State Attorney General Eliot Spitzer, were an apparent manifestation of these incentives.[31] The past few years has seen a pronounced shift in the revenue drivers of many conglomerate investment banks, with much of the total investment banking revenue coming from proprietary trading and principal investing.[32] This has created greater risks for conflicts associated with these activities. The examples of apparent investment banking conflicts in recent transactions, including the proposed buyouts of Kinder Morgan and Alinta, illustrate this point. The current state of affairs in the industry was recently described by *The Economist* as follows:

> …[the investment bank] now finds itself on so many sides of a deal simultaneously that the mind boggles. [Its] [private equity] arms competes with clients (and counts them as customers), and its proprietary arm may trade against

[31] As to these events, see Philip Augar, *The Greed Merchants: How the Investment Banks Played the Free Market Game* (Allen Lane, 2005); Office of New York State Attorney General, "Office of New York State Attorney General Eliot Spitzer, Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interests" (Press Release, 8 April 2002) http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html; (last accessed January 1, 2008); Fisch JE and Sale H, "The Securities Analyst as Agent: Rethinking the Regulation of Analysts" (2003) 88 Iowa Law Review 1035.

[32] See Emily Thornton, et al, "Inside Wall Street's Culture of Risk", Business Week Online, June 12, 2006; Steve Rosenbush, "Investment Banks Jockey for Position", Business Week Online, June 30, 2006.

them. At the same time as it represents a firm, it could be shopping it for sale, attempting to buy it itself, or competing for an acquisition on behalf of another client.[33]

III. Client expectations of loyalty

A. Fiduciary constraints on investment banks

The previous part portrays the conglomerate investment bank as a firm devoted to pursuing its own interests. But an historical perspective of the investment banking industry tells a contrasting story. The industry has long placed a high value on “honorable behavior”, strong client bonds, and the faithful and dedicated service of client interests.[34] Integrity and high ethical standards are “basic to success in the industry.”[35] Client trust, in particular, is regarded as central to the activities, and even to the continued existence, of investment banks.[36] Without trust, an investment bank’s client is less likely – and may even be unwilling – to reveal confidential information to the bank or place its resources at risk by relying on the bank’s advice. Since one measure of an investment bank is its ability to counsel top corporate management,[37] it is not surprising that trust and loyalty are highly valued in the industry.

The notion of investment bank as loyal and trusted adviser is reflected in Morgan Stanley’s public response to the accusation in legal proceedings in the late 1970s that it had betrayed the trust of one of its corporate clients. The firm took the extraordinary measure of placing an advertisement

[33] See “Goldman Sachs: Behind the Brass Plate”, The Economist, April 29, 2006, at pp. 69-70. The term ‘private equity’ has been substituted for the expression ‘merchant banking’ since outside the United States the latter term is often used as a synonym for ‘investment banking’, whereas *The Economist* appears to have intended the expression as a synonym for ‘private equity’.
[34] See Samuel L. Hayes et al., *Competition in the Investment Banking Industry* (Cambridge: Harvard University Press, 1983), ch. 1.
[35] K Thomas Liaw, *The Business of Investment Banking*, *supra* note 14, at 316.
[36] See Alan D Morrison and William J Wilhelm, *Investment Banking: Institutions, Politics, and Law* (Oxford University Press, 2007) at p. 108.
[37] Charles Geisst, *Investment Banking in the Financial System* (Englewood Cliffs, N.J.: Prentice Hall, 1995), at p. 200.

in the *Wall Street Journal* defending itself and insisting that its conduct had adhered to industry standards of practice. The bank was seen to be protecting its "reputation for utter probity in all its activities".[38] The response also shows the lengths to which a major firm may go to assure clients that their high expectations will be met. The Business Principles of Goldman Sachs, another prominent investment bank, reflect a similar high regard for client interests and a desire to maintain the firm's perceived role as a trusted advisor. Goldman Sachs' first principle declares: "Our clients' interests always come first."[39] Another principle acknowledges that its clients regularly entrust it with confidential information and asserts that it would be "unthinkable" for the bank to breach a client's confidence or to use the information "improperly or carelessly".[40]

The apparent trust reposed in investment banks and the expectations of loyalty of their clients raise the prospect of fiduciary obligations arising in a bank's relationships with its clients. Fiduciary doctrine is concerned with maintaining loyalty and fidelity,[41] which it achieves by exacting a standard of propriety in conduct unequalled elsewhere in the law.[42] Although scholars dispute whether an overarching theory explains when a fiduciary relationship exists, courts – particularly in recent decisions – give emphasis to whether, within the scope of the particular relationship, a person can be reasonably expected to act in the interests of another in and for the purposes of the relationship.[43] Framed from the perspective of the other party to the relationship, the inquiry is whether that person is entitled to expect that the other will act in his interests.[44] The

[38] Warren A. Law, "Wall Street and Regulation" in Samuel L. Hayes, ed., *Wall Street and Regulation* (Harvard Business School Press, 1987) 157, at p. 167.
[39] See http://www2.goldmansachs.com/our_firm/our_culture/business_principles.html (last accessed 15 December 2007).
[40] *Ibid*.
[41] Paul D Finn, "The Fiduciary Principle" in T G Youdan ed., *Equity, Fiduciaries and Trusts* (1989) ("The Fiduciary Principle") 1, at pp. 2, 25.
[42] See Andrew Tuch, "Investment Banks as Fiduciaries: Implications for Conflicts of Interest" (2005) 29 Melbourne University Law Review 478, at pp. 479-483.
[43] *Hughes Aircraft Systems International* v. *AirServices Australia (No. 3)* (1997) 76 F.C.R. 151, at p. 237; *Australian Securities Commission* v. *AS Nominees Ltd* (1995) 62 F.C.R. 504, at 521 (Finn J.); *Gibson Motorsport Merchandise Pty Ltd* v. *Forbes* [2006] F.C.A.F.C. 44 (31 March 2006), at [12]; (2006) 149 F.C.R. 569; *Rawley Pty Ltd (ACN 009 027 454)* v. *Bell (No. 2)* (26 April 2007) [2007] F.C.A. 583, at [261].
[44] "The Fiduciary Principle", *supra* note 41, at p. 46.

reasonable expectations criterion has recently been critiqued by Professor Deborah DeMott who has recommended a criterion that focuses on the justifiability of the expectation of loyalty.[45] Other indicia have also been judicially endorsed for identifying fiduciary character.[46] It is clear, however, that courts will have regard to the expectations of loyalty engendered in a relationship to determine the existence of fiduciary obligations.

The issue in the present context is whether, in performing their traditional functions of providing financial advisory services or underwriting securities offerings, investment banks will face fiduciary constraints. Against the backdrop of the organizational structure of these firms, the practical difficulty becomes obvious. How can a firm whose structure produces conflicts of interest (and may even render them inevitable) satisfy such an exacting obligation of loyalty?

The relevant fiduciary analysis of both relevant relationships – between an investment bank and its financial advisory client or underwriting client – has been set out in detail elsewhere.[47] It is summarized here. Neither relationship is established by precedent as having fiduciary character. Accordingly, whether fiduciary obligations arise must be assessed in each individual case and this requires a factual assessment of the relationship in question. While no two transactions are identical, standardized patterns of performing these traditional services have evolved over time and are applied in transaction after transaction by firms across the industry.[48] In view of this,

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[45] See Deborah A DeMott, "Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences" (2006) 48 Arizona L. Rev. 925.

[46] These include the existence of an undertaking by a person (the fiduciary) to act in the interests of another person, a relation of trust and confidence, vulnerability to another's power or vulnerability necessitating reliance, power held by a person (the fiduciary) to affect the interests of the other person in a real or practical sense.

[47] See Andrew Tuch, "Securities Underwriters in Public Capital Markets: The Existence, Parameters and Consequences of the Fiduciary Obligation to Avoid Conflicts" (2007) 7 Journal of Corporate Law Studies, 51; Andrew Tuch, "Obligations of Financial Advisers in Change-of-Control Transactions: Fiduciary and Other Questions" (2006) 24 Company & Securities Law Journal 488; and Andrew Tuch, "Investment Banks as Fiduciaries: Implications for Conflicts of Interest" (2005) 29 Melbourne University Law Review 478. Note that the fiduciary analysis in the underwriting context is confined to the initial public offering of an issuer and may not necessarily apply in other contexts.

[48] As to the historical development of the investment banking pattern adopted to underwrite securities offerings, see *United States* v. *Morgan* 118 F..Supp. 621 (1953), at 635-655. The opinion describes the

these two relationships may be described with sufficient precision to allow an assessment of their fiduciary character. Nevertheless, the fiduciary question in these contexts is a factual one. In any given transaction the relevant relationship may differ from the description provided here; in that case, the fiduciary analysis may produce a different outcome.

In both the financial advisory and underwriting contexts, the investment bank's role is one of trusted financial or investment counselor. This is hard to deny in the financial advisory context, where a firm's client is pitted in a public, highly adversarial manner against another party in a transaction involving the change of control of one of the adversaries. The underwriting context is more complex, since the investment bank's underwriting role in fact includes numerous functions.[49] It markets and distributes the issuer's shares and assumes the risk that not all the shares will be purchased by the public. By lending its name as underwriter to the transaction, the investment bank also performs the "gatekeeping" role of signaling to the market the quality of the issuer and its shares. Of most significance, the investment bank also performs a financial advisory role along similar lines to the role it performs in the financial advisory context. The advisory role is a core feature of the underwriter's work and is most prominent in the initial public offering of an issuer.

In both contexts, the investment bank brings to bear its extensive transactional experience and financial acumen for the client's benefit. The client discloses confidential information, however sensitive, to allow its advisor to advise on the wisdom, merits, timing, structure, pricing and execution of the proposed transaction (the takeover or related transaction in the financial advisory

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development "of a single effective method of security underwriting and distribution" whose "form and development were due entirely to the economic conditions in the midst of which investment bankers functioned" (at 640). It describes "the elaborate and effective modern methods by which investment bankers, skilled in the application of their special techniques, perform the integrated services by which they earn their livelihood" (at 641).

[49] See Andrew Tuch, "Securities Underwriters in Public Capital Markets: The Existence, Parameters and Consequences of the Fiduciary Obligation to Avoid Conflicts", *supra* note 47, at pp. 54-61.

context, the initial public offering in the underwriting context) and of alternative transactions. In both contexts, the relationship between the investment bank and its client will be a close one.

It is the giving of financial or investment advice by the investment bank that will support the imposition of fiduciary obligations. Under Anglo-Australian law, a line of cases establishes that fiduciary obligations may be imposed in a commercial context on a party in a relationship of confidence where an incident of the relationship is the giving of financial or investment advice.[50] More specifically, the relationships of stockbroking firm and client,[51] bank and customer,[52] corporate adviser and client,[53] and analogous relationships, have been found to be fiduciary where the adviser has held itself out as an expert in financial or investment matters and undertaken to provide advice of that nature to the client or customer.[54] This formulation – holding out and undertaking by the adviser – has been equated with a requirement that the adviser's conduct create in the client an expectation that it will advise in the client's interests, an apparent reference to the reasonable expectations criterion referred to above.[55] It follows that neither the commercial nature of an investment bank's dealings with its client nor the sophistication or apparent lack of vulnerability of a client will pose a barrier to the possibility of fiduciary obligations arising.[56]

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50 For a more detailed discussion of the law, see Tuch, "Investment Banks as Fiduciaries: Implications for Conflicts of Interest", *supra* note 47.
51 See, *eg.*, *Daly* v. *Sydney Stock Exchange* (1986) 160 C.L.R. 371.
52 See, *eg.*, *Commonwealth Bank of Australia* v. *Smith* (1991) 42 F.C.R. 390; *cf Finding* v. *Commonwealth Bank of Australia* [2001] 1 Qd. R. 168.
53 See, *e.g*, *Aequitas Ltd* v. *Sparad No 100 Ltd (formerly Australian European Finance Corporation Ltd)* (2001) 19 A.C.L.C. 1006 ("Aequitas"); *cf Arklow Investments Ltd* v. *Maclean* [2000] 1 W.L.R. 594.
54 See *Daly* v. *Sydney Stock Exchange* (1986) 160 C.L.R. 371, at 385 and *Aequitas* (2001) 19 A.C.L.C. 1006, [307].
55 See *Commonwealth Bank of Australia* v. *Smith* (1991) 42 F.C.R. 390, at 391 where the Full Federal Court of Australia (Davies, Sheppard and Gummow JJ.) apparently saw the "fiduciary expectation" requirement as grounded in *Daly* v. *Sydney Stock Exchange* (1986) 160 C.L.R. 371, which established the requirement of holding out and undertaking.
56 As discussed below, Justice Jacobson in *ASIC v Citigroup* referred with approval to this analysis of the case law. See *ASIC v Citigroup*, at [254] – [292] and [322] – [339].

The cases also demonstrate that where fiduciary obligations do arise, their scope will be confined to the giving of advice of the requisite type.[57] Accordingly, fiduciary obligations will be imposed "to the extent of the advice"[58] or only in respect of the advisory aspect or dimension of the relationship. It follows that fiduciary obligations may not be owed in respect of other aspects of the relationship between an investment bank and its client,[59] assuming of course that aspects of a relationship can be discretely identified.

In the usual course, and leaving aside the question of whether fiduciary obligations have been contractually displaced or varied, a real risk exists that an investment bank performing its traditional roles will face fiduciary constraints. In both the financial advisory and underwriting contexts, it is plausible that the close relationship between bank and client, involving the bank giving financial or investment advice and the client disclosing confidential and sensitive information and reposing trust, will give rise to a reasonable expectation by the client of loyalty from its adviser. For transaction planning purposes, parties would do well to consider that fiduciary obligations arise in the absence of special factors such as contractual variation or exclusion.

B. Discharging fiduciary obligations

The classic formulation of fiduciary obligations requires the fiduciary to avoid conflicts of interest without a client's fully informed consent and not to obtain any unauthorised profit from the fiduciary relationship.[60] The two obligations – to avoid conflicts and not obtain unauthorised profits – overlap in the sense that the same conduct may breach both. Breach of either obligation

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[57] In *Daly's case*, the question was framed as whether, "in advising its client", the stockbroking firm was in the position of a fiduciary. See *Daly* v. *Sydney Stock Exchange* (1986) 160 C.L.R. 371, at 384.
[58] John Glover, *Equity, Restitution and Fraud* (LexisNexis Butterworths, 2004), at para. 2.67.
[59] Numerous cases establish that a person may be a fiduciary in one or more activities but not in others: *New Zealand Netherlands Society "Oranje" Inc.* v. *Kuys* [1973] 1 W.L.R. 1126, 1130; *Phipps* v. *Boardman* [1967] 2 A.C. 46, 127; *Birtchnell* v. *Equity Trustees Executors & Agency Co. Ltd* (1929) 42 C.L.R. 384, 408; *Hospital Products Ltd* v. *United States Surgical Corporation* (1984) 156 C.L.R. 41, 98.
[60] See *Breen* v. *Williams* (1996) 186 C.L.R. 71, at 113 (Gaudron and McHugh JJ.), 137-138 (Gummow J.).

exposes the fiduciary to equity's gain-stripping remedies. The focus of this essay is on the former obligation since it more directly relates to conflicts of interest.

The imposition of the fiduciary obligation to avoid conflicts creates potentially intractable problems for the conglomerate investment bank, as discussed above. Such an obligation may well require the firm to decline work (assuming it detects the conflict early enough) or to take the more dramatic step of narrowing its range of operations to avoid inescapable or potentially undetectable conflicts. The pragmatic response of investment banks, however, has been to adopt structural and contractual techniques to avoid these unappealing consequences.

The structural techniques used by firms include erecting Chinese walls. These are internal policies and procedures that restrict the flow of information within a firm to ensure that information that is confidential to one department or segment of operations is not improperly communicated to another within the firm.[61] Despite their widespread use in the financial services industry,[62] observers are suspicious of the extent to which they are enforced by firms.[63] More significantly, Chinese walls do not – as a matter of legal principle – prevent a breach of the fiduciary obligation to avoid conflicts of interest,[64] even where the various functions within a firm are segregated. In broad terms, this is because Chinese walls fail to put an end to the position

[61] For a description of Chinese walls, see Fiduciary Duties and Regulatory Rules 1992 Paper, *supra* note 12, at para. 4.5.
[62] Fiduciary Duties and Regulatory Rules 1992 Paper, *supra* note 12, at para. 4.5.
[63] See, eg., Landon Thomas, "Size Doesn't Keep Goldman Fund From Gyrating With Market" *New York Times*, August 10, 2007 (commenting on the proprietary trading division and hedge funds within investment bank Goldman Sachs, the article asserts that"[w]hile the firm has always said that there is a Chinese wall separating the firm's hedge funds from its [proprietary] traders, it has long been felt on Wall Street that good investment ideas, or bad ones for that matter, are to some degree shared at the firm." These concerns may be exacerbated by the practice of bankers being transferred within divisions of a firm, the article reports).
[64] Fiduciary Duties and Regulatory Rules 1992 Paper, *supra* note 12, at para. 7.15. See also Andrew Mitchell, 'Whose Side Are You on Anyway? Former Client Conflict of Interest' (1998) 26 Australian Business Law Review 418 at 429. However, Chinese walls may be effective in some transactions where, on the basis of the decision in *Kelly* v. *Cooper* [1993] A.C. 205, there is an express contractual term between the firm and client limiting the scope of fiduciary obligations and giving effect to Chinese walls. Such a contractual term would provide that the firm uses Chinese walls and that the client is not entitled to any information which the actual member of the firm with whom he or she deals does not have in his or her possession: Fiduciary Duties and Regulatory Rules 1992 Paper, *supra* note 12, at para. 3.34.

of conflict, the very existence of which may constitute a breach of the fiduciary obligation. The vice against which fiduciary obligation guards is the "compromising of a fiduciary's duty of loyalty", not the possibility that confidential information will be misused (against which Chinese walls will guard).[65]

Contractual techniques rely on the principle that the scope of the fiduciary relationship must "accommodate itself to the terms of the contract [underlying the relationship] so that it is consistent with, and conforms to, them."[66] It follows that where the contract between parties would provide the basis for the existence of fiduciary obligations, the contract itself may vary or displace the fiduciary relationship. The provisional view of the UK Law Commission was that although contractual techniques "could not safely be relied on in all cases", with limited exceptions "no restrictions operated as a matter of fiduciary law to prevent a fiduciary from contracting out of or modifying his fiduciary duties, particularly where no prior fiduciary relationship existed and the contract sought to define the duties of the parties."[67] In *ASIC v Citigroup*, Jacobson J referred with approval to the latter statement, holding that an exclusion clause was effective to prevent fiduciary obligations from arising.[68] Of course, the situation may be different where a fiduciary relationship pre-exists the relevant contract.[69] In the case where

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[65] See *ASIC v Citigroup*, *supra* note 1, at [312] – [313], quoting UK Law Commission at [4.5.1] and P D Finn, "Fiduciary Law and the Modern Commercial World", Norton Rose Oxford Law Colloquium (1991) at 13.

[66] *Hospital Products Ltd* v. *United States Surgical Corp* (1984) 156 C.L.R. 41, 97 (Mason J.). His Honour further explained that the fiduciary relationship cannot be superimposed upon the contract in such a way as to alter the operation which the contract was intended to have according to its true construction.

[67] Law Commission, United Kingdom, *Fiduciary Duties and Regulatory Rules* (Law Com. No. 236, 1995) ("Fiduciary Duties and Regulatory Rules 1995 Report"), at para. 1.10 and 2.11.

[68] For example, in *ASIC v Citigroup*, *supra* note 1, Jacobson J ruled that the exclusion clause in the mandate (or engagement) letter between an investment bank and its financial advisory client was effective to a fiduciary relationship from arising. His Honour asserted that the clause should be given its plain meaning (at [324]) and was effective to prevent fiduciary obligations from arising (at [337]). Although he raised public policy concerns about investment banks being able to contractually displace fiduciary obligations in the advisory relationship (at [602]), Jacobson J indicated that investment banks were free to contractually displace or modify the existence of fiduciary obligations, but could not limit "liability for fraud or deliberate dereliction of duty" (at [280]).

[69] Where this occurs, informed consent to the inclusion of the provision itself may be required for it to be effective. See, generally, *ASIC v Citigroup*, *supra* note 1, at [297] to [397], citing *Law Society of New South*

fiduciary obligations are contractually displaced, legislation may provide the only rules regulating how investment banks must respond to conflicts of interest.

C. Co-existence of statutory conflict management obligations

In recognition of the potential for conflicts of interest in the financial services industry and in response to concern about the role of conflicts in the wave of corporate collapses early this century, regulators have waded in with solutions of their own. In Australia, for example, federal parliament amended the *Corporations Act* 2001 (Cth) to require investment banks, as holders of financial services licences, to "have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee… in the provision of financial services as part of [their] financial services business".[70] The provision became effective on 1 January 2005. Nothing about the legislative process suggests that the provision was intended to displace or modify the general law of fiduciary obligations.

Where legislation regulating conflicts at investment banks co-exists with fiduciary obligations, difficult questions may arise. As mentioned at the outset, these include the extent to which the classic formulation of fiduciary obligations takes account of both the conglomerate structure of the modern investment bank and the co-existence of statutory obligations. For example, where statute requires a lesser standard of conduct than fiduciary doctrine or where it assumes the existence of conduct that fiduciary principles would normally prohibit, does this affect the content of fiduciary obligations? What does the obligation to "manage" conflicts require? And how does such an obligation differ from or relate to the general law duty to protect confidential

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Wales v. *Foreman* (1994) 34 N.S.W.L.R. 408; *Re Morris Fletcher* v. *Cross' Bill of Costs* [1997] 2 Qd. R. 228; *McNamara Business & Property Law* v. *Kasmeridis* [2007] S.A.S.C. 90; *Symonds* v. *Raphael* (1998) 148 F.L.R. 171.

[70] *Corporations Act 2001* (Cth), s. 912A(1)(aa). The provision was described as a response to general concerns about conflicts of interest in the financial services industry following the wave of corporate collapses in the United States and internationally early this century. See Commonwealth Parliament, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 Explanatory Memorandum*, at para. 5.592 to 5.597.

information? In principle, these questions can also arise in other regulated contexts.[71] They are considered in the remainder of the essay in the context of *ASIC v Citigroup*.

III. ASIC v Citigroup

ASIC v Citigroup involved alleged conflicts of interest generated by the organisational structure of a major financial services conglomerate and offers a rare, and perhaps unprecedented, instance of judicial scrutiny of both the relationship between an investment bank and its financial advisory client and the interrelationship between fiduciary obligations and a statutory obligation to manage conflicts.

Citigroup was engaged as financial advisor to Toll Holdings in its proposed bid for Patrick Corporation, its primary competitor in the logistics business. On the business day prior to Toll announcing its proposed takeover, Citigroup purchased over one million shares in Patrick. The shares were purchased on the bank's own account, not on behalf of clients of the bank, by proprietary traders within the firm whose job it was to trade for profit on the firm's account. Like other major conglomerate investment banks, Citigroup operated separate business units, one of which housed the bankers advising Toll on the proposed takeover and another conducting the trading. At the time the shares were purchased, the Citigroup trader had no knowledge that Citigroup was advising Toll on a transaction involving Patrick, there being in place Chinese walls that prevented his access to the information. However, there was press speculation that such a deal was in the works.

Justice Jacobson's opinion includes a detailed description of the events leading up to Citigroup's retention as Toll's adviser. As the proposed transaction took shape and became more certain, Citigroup's pleas to be retained in an advisory capacity became increasingly desperate. In

[71] Law Fiduciary Duties and Regulatory Rules 1992 Paper, *supra* note 12, at para. 1.2.

numerous email missives, Citigroup's lead banker lauded his firm's ability and experience and referred to its being willing to "back [Toll] to the hilt even if [the transaction] gets a little hairy".[72] When finally signed, the engagement letter included an acknowledgement that Citigroup has been engaged "as an independent contractor and not in any other capacity including as a fiduciary."[73] These words were ultimately dispositive of the case.

ASIC alleged that Citigroup's stake in Patrick, as well as the conduct of officers at the bank once the trading became known, generated conflicts of interest that placed the firm in breach of the fiduciary obligation it owed Toll and its statutory obligation to manage conflicts under the *Corporations Act*. In broad terms, Citigroup's stake allegedly gave it a financial interest in Patrick's price appreciating, putting Citigroup in a position of conflict with the interests of Toll as a proposed purchaser of Patrick.

A fundamental point in ASIC's case was that "Citigroup, as an adviser to Toll... occupied a relationship which was, in critical respects, fiduciary."[74] Accordingly, "Citigroup was obliged not to allow itself to be placed in a position of actual or potential conflict between its duty of loyalty to Toll and its interest in the profits sought to be obtained from its proprietary trading in Patrick shares."[75] ASIC also contended that the statutory obligation required Citigroup to *avoid* positions of conflict, in the absence of Toll's informed consent – a claim that, for forensic reasons, ASIC said depended on the existence of a fiduciary relationship.[76] The central issue was thus whether the relationship between Citigroup and Toll was fiduciary, a question that turned on the

[72] *ASIC v Citigroup*, at [99] – [111]. The contract also provided that Toll "should be aware that Citigroup… may be providing or may in the future provide financial or other services to other parties with conflicting interests." (at [145]). Citigroup argued that this also indicated that no fiduciary relationship arose between the parties. In his reasons, Justice Jacobson does not address this argument.
[73] *Ibid.*, at [145].
[74] *Ibid.*, at [14]. ASIC also alleged that Citigroup had engaged in insider trading. These claims were dismissed and are not pursued here.
[75] *Ibid*.
[76] *Ibid.*, at [422].

effectiveness of contractual provisions in Citigroup's engagement letter with Toll that purported to exclude the existence of that relationship.[77]

Justice Jacobson dismissed ASIC's claims, ruling that Citigroup's engagement letter prevented a fiduciary relationship from arising at the time the contract between the parties was executed. Although the exclusion clause was effective, Justice Jacobson suggests that in the absence of the clause the relationship would have been fiduciary in character. "But for the express terms of the mandate letter," he reasons, "the pre-contract dealings between Citigroup and Toll would have pointed strongly toward the existence of a fiduciary relationship in Citigroup's role as an adviser."[78] Moreover, the pre-contract dealings "contain all of the indicia of a fiduciary relationship of adviser and client."[79] Justice Jacobson refers to numerous indicia including Citigroup's "advice as to the wisdom and merits of the bid", its use of "financial acumen, judgment and expertise to further Toll's interests", its close working relationship with Toll, and its "pitch" to be retained by Toll, which involved the firm trumpeting its abilities and commitment to the deal.[80] The magnitude of Citigroup's fees was also relevant; they ranged from A$10 million to A$18 million depending on the terms of the final successful deal. The fees "are testimony in themselves to a finding that Citigroup held itself out as an expert adviser on mergers and acquisitions, which points to the existence of a fiduciary relationship."[81] While not required to answer the question, Justice Jacobson's reasons suggest he would have found that fiduciary obligations *pre-existed* the contract.

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[77] ASIC also claimed that Citigroup had breached insider trading provisions of the *Corporations Act* 2001 (Cth) when one of its proprietary traders sold shares in Patrick that had been accumulated earlier that day (on the business day prior to the takeover announcement). The Federal Court rejected these claims. They are not discussed in this essay.
[78] *Ibid.*, at [325].
[79] *Ibid.*, at [326].
[80] *Ibid.*, at [326] to [329].
[81] *Ibid.*, at [330].

The existence of a prior fiduciary relationship is relevant to the effectiveness of an exclusion clause purporting to eliminate the existence of that relationship. Relying on the UK Law Commission, Justice Jacobson asserts that fiduciary obligations may be contractually excluded, except for fraud or deliberate dereliction of duty, but confines this rule to situations where "no fiduciary relationship existed and the contract defines the rights and duties of the parties".[82] His reasons avoid any suggestion that an exclusion clause will be effective to eliminate a fiduciary relationship that pre-existed the contract. In addition, Justice Jacobson points to some authorities that suggest informed consent may be required for an exclusion clause to effectively displace fiduciary obligations, but says that this principle applies only "to those within an established category of fiduciary relationship or, at the very least, to those who carry fiduciary obligations before the execution of the contract".[83] However, as Justice Jacobson observes in multiple places throughout the judgment, ASIC's case was that the fiduciary relationship between Citigroup and Toll arose from the contract; ASIC "specifically eschewed any suggestion that the fiduciary relationship arose prior to the execution of the mandate letter".[84] Accordingly, Justice Jacobson was not required to decide, and carefully avoids discussing, whether the exclusion clause in Citigroup's engagement letter would have been effective to displace a fiduciary relationship that pre-dated that contract. This unanswered question is significant considering the pre-contract dealings between Citigroup and Toll "pointed strongly" toward such a pre-existing relationship.[85]

The case suggests two important propositions. First, in the absence of a clearly-worded exclusion clause in an engagement letter between an investment bank and its financial advisory client,

[82] *Ibid.*, at [280].
[83] *Ibid.*, at [305], citing *Law Society of New South Wales* v. *Foreman* (1994) 34 N.S.W.L.R. 408; *Re Morris Fletcher* v. *Cross' Bill of Costs* [1997] 2 Qd. R. 228; *McNamara Business & Property Law* v. *Kasmeridis* [2007] S.A.S.C. 90; *Symonds* v. *Raphael* (1998) 148 F.L.R. 171.
[84] *Ibid.*, at [306]; see also [24].
[85] The reasons suggest that Citigroup may have been fortunate that ASIC alleged only that fiduciary obligations arose when the engagement letter was executed rather than earlier in the advisory process. Nevertheless, it is doubtful that the outcome of the case would have been different had ASIC made this argument since the Court was not convinced that the alleged conflicts of interest occurred.

fiduciary obligations may well exist between the parties. Second, where fiduciary obligations pre-exist the engagement letter, investment banks can have no confidence that the exclusion clause alone will be effective to free it from fiduciary constraints. The lesson for dealmakers is to pay attention to both the content of the exclusion clause and the timing of its execution. Executing the letter late in the advisory process increases the risk that fiduciary obligations will arise and diminishes the likely effectiveness of any exclusion clause. The lesson for clients is that they may gain some advantage by executing the letter later in the process.

The case should not be regarded as signalling business as usual for investment banks. While exclusion clauses are in widespread use, it is not universal industry practice to execute engagement letters at the outset of the advisory relationship – as the Citigroup matter itself demonstrates. Investment banks underwriting securities offerings may also need to reconsider their existing practices. As discussed in Part II, the relationship between an investment bank as underwriter and its issuer client may be fiduciary in character (particularly in the IPO context) unless effective contractual techniques are adopted at the outset of the advisory relationship. In the underwriting context, as in the financial advisory context, it is not (or at least *was not* until very recently perhaps) industry practice in Australia to execute engagement letters at the outset of the relationship between an underwriter and its issuer client.[86]

IV. The content of fiduciary obligations

Will the fiduciary obligation *to avoid conflicts* apply in the investment banking context or will the obligation be adapted to "take account of the way modern commercial organisations are organised and regulated," as the UK Law Commission recommended in a related context?[87]

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[86] For a description of industry practices in the underwriting context, see Andrew Tuch, "Securities Underwriters in Public Capital Markets: The Existence, Parameters and Consequences of the Fiduciary Obligation to Avoid Conflicts" (2007) 7 Journal of Corporate Law Studies 51.
[87] Fiduciary Duties and Regulatory Rules 1992 Paper, *supra* note 12, at para. 6.16; see also para. 1.10.

Courts claim to mould fiduciary obligations to the character of a particular relationship[88] and in doing so take into account the commercial context in which a relationship is situated or a transaction takes place.[89] For present purposes, the relevant context includes the conglomerate structure of investment banks, the regulatory framework permitting these organisations to exist, and the potential the structure creates for conflicts of interest to occur.

In *ASIC v Citigroup*, the court gave this question little explicit consideration. Before turning to Justice Jacobson's reasons, however, several issues deserve analysis. The first is whether, because of the structure of the integrated investment bank or its particular role as financial adviser or underwriter, there exists in the contract with its client an implied term that attenuates the content or even the scope of any fiduciary obligations that arise. In *Kelly* v. *Cooper*[90] the Privy Council implied into a contract between parties in a fiduciary relationship a term permitting the fiduciary to engage in an activity that would inevitably place it in a position of conflict with its client. The case centred on a real estate agent, an advisor who typically acts for both buyer and seller on a single transaction. The plaintiff was found to be "well aware" that the agent would be put in that position of conflict.[91] The investment banking roles are sufficiently distinguishable from the real estate agent's role that such a term is unlikely to be implied in the investment banking contexts being considered here.[92]

Second, as a policy matter, courts should exercise caution before attempting to articulate either the "commercial context" in which these investment banking relationships are situated or the

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[88] *United Dominions Corporation Ltd* v. *Brian Pty Ltd* (1985) 157 C.L.R. 1 at 11; 60 A.L.R. 741, citing *Birtchnell* v. *Equity Trustees, Executors and Agency Co Ltd* (1929) 42 C.L.R. 384 at 407-409.
[89] The "commercial reality" has influenced courts in shaping the fiduciary obligations of nominee directors. See, *eg Levin* v. *Clark* (1962) 80 W.N. (N.S.W.) 485; [1962] N.S.W.R. 686, *Re Broadcasting Station 2GB Pty Ltd* [1964-65] N.S.W.R. 1648 and *Berlei Hestia (NZ) Ltd* v. *Fernyhough* [1980] 2 N.Z.L.R. 150 at 165-166.
[90] *Kelly* v. *Cooper* [1993] A.C. 205.
[91] *Ibid.*, at 215.
[92] See Andrew Tuch, "Obligations of Financial Advisers in Change-of-Control Transactions: Fiduciary and Other Questions" (2006) 24 Company and Securities Law Journal 488 at 510-512.

organizational form of investment banks. As discussed above, investment banks innovate rapidly, their business mix shifting as they search out ever-more lucrative business opportunities.[93] In view of this, it is unlikely that a snapshot of current investment banking structures or practices would have enduring benefit for identifying the commercial context in which the financial advisory and underwriting relationships are situated or how firms are organized. Indeed, judicial attempts to mould fiduciary obligations according to what may be described as "commercial reality" are likely to add further regulatory uncertainty to the regulation of conflicts in the investment banking industry.

Third, whatever changes may have occurred in the industry, it is doubtful whether client expectations of loyalty of their financial advisers and underwriters have changed. Client expectations are a focal point of courts' attention in determining whether fiduciary obligations exist. Moreover, adapting the content of fiduciary obligations based on a firm's organizational structure would produce anomalous results.[94] Where a client appoints two or more financial advisers for a single transaction, an increasingly common phenomenon,[95] will a firm's obligation vary according to its structure? If so, an independent investment bank that has eschewed the conglomerate structure might owe an obligation different in content from its co-advisor. From a policy perspective, such a doctrinal approach would also contribute to regulatory uncertainty and should be avoided.

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[93] See Thal Larsen P, "Banks Face Big Test to Keep Clients", Financial Times (31 May 2006): "[In the past five years] investment banks have expanded into other areas, partly by using their own capital. Proprietary trading is now a significant source of income for many investment banks while some … have also become prominent private equity investors."

[94] See Andrew Tuch, "Obligations of Financial Advisers in Change-of-Control Transactions: Fiduciary and Other Questions" (2006) 24 Company and Securities Law Journal 488 at 510-512.

[95] Maiden M, "When Bankers Collide", The Age (3 June 2006). The following comment is attributed to Mr John Wylie: "The fact is, the model the client increasingly prefers is a big bank with a boutique bank [independent advisory firm] side by side: clients feel that both types of organisations bring something to the party."

Turning now to *ASIC v Citigroup*, Justice Jacobson does not explicitly address the issue of whether Citigroup's organizational structure is relevant to determining the content of any fiduciary obligations that arose. In his reasons, Justice Jacobson contrasts the fiduciary obligation with the statutory obligation to manage conflicts. Whereas the statutory obligation in Australia requires the management of conflicts of interest, he says, equity requires a fiduciary "to eliminate or avoid conflicts".[96] Despite discussing the structure of investment banks, the diversity of the services they offer, and the potential their structure creates for conflicts,[97] Justice Jacobson nowhere suggests that these factors play any role in shaping the content of fiduciary obligations. He also dismisses the potential application of *Kelly* v. *Cooper*, asserting that "there is nothing in the relationship of investment banker/ financial advisor and client which requires a conclusion that it is an inherent part of the business of investment banking for the banker to engage in trading in its client's target's shares."[98]

Justice Jacobson's approach is consistent with the approach in recent case law. In *Commonwealth Bank of Australia* v. *Smith*, a case in which the fiduciary was a commercial bank offering multiple products and services, the Full Federal Court explained that the fiduciary was obliged to "avoid, without informed consent, placing [itself] in a position of conflict between duty and personal interest".[99] The court did not suggest that the content of the obligation varied because of the fiduciary's conglomerate structure. In *Aequitas Ltd.* v. *Sparad No. 100 Ltd*, Justice Austin expressed the fiduciary obligation in a similar way in a case involving a merchant bank providing financial advisory services. In the absence of the client's informed consent, Justice Austin explained, the obligation prohibited the fiduciary from occupying positions of conflict between

[96] *ASIC v Citigroup*, at [311]), citing *Breen* v. *Williams* (1996) 186 C.L.R. 71, at 108 (Gaurdon and McHugh JJ.).
[97] *Ibid*., at [254] to [269].
[98] *Ibid*., at [360].
[99] *Commonwealth Bank of Australia* v. *Smith* (1991) 42 F.C.R. 390 at 392.

duty and personal interest.[100] Financial conglomerate or not, the cases suggest, the investment bank as fiduciary will be obliged to avoid conflicts in the absence of its client's informed consent. The standard of conduct required of the fiduciary is not diminished by reason of its organizational structure.

But a firm's structure may nevertheless be relevant to the question of informed consent. As Justice Jacobson observes, no precise formula exists for determining whether informed consent has been provided.[101] Where provided by the client, informed consent "[absolves] the fiduciary from liability for what would otherwise be a breach of duty".[102] Toll's informed consent to Citigroup's proprietary trading in Patrick is implied from Toll's "knowledge of Citigroup's structure and method of operations"[103] and its sophistication and experience in similar transactions.[104] The relevant knowledge was that "Citigroup was a large financial conglomerate which did not act exclusively for Toll" and "had a proprietary trading desk which could operate for the benefit of Citigroup so long as knowledge of Toll's confidential information did not leak to the proprietary traders."[105] In addition, Toll's Chief Financial Officer "accepted that Citigroup could trade for third parties or for itself, so long as it did not use Toll's confidential information."[106] Justice Jacobson concludes this part of his reasons by saying that in the particular circumstances of the case "Toll had sufficient knowledge of the real possibility of proprietary trading by Citigroup to amount to informed consent."[107]

The finding of informed consent may hearten advisors to investment banks. But it must be remembered that Toll appears not to have complained about Citigroup's conduct, but rather was

[100] *Aequitas Ltd* v. *Sparad No 100 Ltd (formerly Australian European Finance Corporation Ltd)* (2001) 19 A.C.L.C. 1006, at 1065.
[101] *ASIC v Citigroup*, at [294].
[102] *Ibid.*, at [293], citing *Commonwealth Bank of Australia* v. *Smith* (1991) 42 F.C.R. 390 at 393.
[103] *Ibid.*, at [355].
[104] *Ibid.*, at [355].
[105] *Ibid.*, at [356].
[106] *Ibid.*, at [357].
[107] *Ibid.*, at [361].

cast unwillingly into the role of victim by ASIC. Where proceedings for breach of fiduciary obligations are brought by an aggrieved client, rather than the financial regulator, an investment bank is less likely to benefit from factual findings about the client's knowledge.

A related question is whether the content of fiduciary obligation may vary due to the co-existence of a statutory obligation, such as the obligation in Australia to "manage" conflicts. Justice Jacobson reasons also suggest a negative answer to this question. Justice Jacobson contrasts the content of the fiduciary and statutory obligations[108] and nowhere suggests that the statutory obligation is relevant to the content of fiduciary obligation. He does, however, comment on the content of the statutory obligation, as the next part explains.

V. The statutory conflict management obligation

ASIC's claim that Citigroup breached it statutory obligation under s912A(1)(aa) of the *Corporations Act* to manage conflicts of interest also failed. For forensic reasons, ASIC argued that the statutory obligation applied only if Citigroup's relationship with Toll was fiduciary; in consequence, the statutory and fiduciary claims fell together.

Despite ASIC's concession in the case, the fiduciary and statutory obligations appear to be independent. They vary in terms of their content and source. It is difficult to see why, in other situations, one of the obligations could not arise in the absence of the other. For example, it is plausible that where the fiduciary obligation does not arise, perhaps because it has been contractually excluded, an investment bank will nevertheless be subject to the statutory obligation. In that case, in particular, the content of the statutory obligation will take on significance.[109] Determining its meaning is difficult, in part because the expression "managing

[108] *Ibid.*, at [311]), citing *Breen* v. *Williams* (1996) 186 C.L.R. 71, at 108 (Gaurdon and McHugh JJ.).
[109] For a similarly worded obligation, see Financial Services Authority Handbook, "Principles of Business". These principles are general statements of the main regulatory obligations that apply to every authorized

conflicts" is widely deployed by both regulators and investments banks with little apparent attempt to explain its meaning.[110] This part attempts to clarify the meaning of this elusive expression.

A. Content of the obligation

The expression "management of conflicts of interest" is nowhere defined in the statute and Australian and English courts appear not to have opined on its meaning in this or other contexts. Due to the way ASIC framed its case, Justice Jacobson was not required to determine the meaning of the obligation to manage conflicts or whether Citigroup satisfied it. ASIC argued that the statutory provision was "not engaged unless Citigroup and Toll were in a fiduciary relationship" and Justice Jacobson found against ASIC on the fiduciary claim.[111] He nevertheless briefly addressed both issues.

As to the meaning of conflict management, Justice Jacobson rejects ASIC's submission that managing conflicts under the *Corporations Act* required Citigroup to eliminate any unauthorized conflicts by obtaining express consent, explaining that this proposition is "inconsistent with the plain meaning of s912A(1)(aa)."[112] He further explains:[113]

> First, the subsection uses the words "management of conflicts of interest". I do not see that "management" requires elimination of a possible conflict, although

firm. Principle 8 requires a firm to "manage conflicts of interest fairly, both between itself and its customers and between a customer and another client".

110 See, *eg.*, Hector Sants, "Market abuse and conflicts of interest: The FSA approach", Speech to The Financial Crime Forum Asia Pacific, Hong Kong, June 5, 2006. Speaking on behalf of the FSA, Mr Sants explained that "[w]e believe it is the responsibility of a firm's senior management to implement arrangements, policies and procedures to manage conflicts effectively."

111 See *ASIC v Citigroup*, at [422] and [441]. Note that even if the relationship between Citigroup and Toll had been fiduciary in character, the statutory obligation would not have applied to Citigroup because of the operation of the exemption in the regulations under the statute, Jacobson J. held (at [440]).

112 *Ibid.*, at [443].

113 *Ibid.*, at [444] – [445].

> of course it would be open to a licensee to take that further step if it chooses to do so.
>
> Second, the phrase "management of conflicts of interest" assumes that there will be potential conflicts which must be managed by adequate arrangements rather than totally eliminated.
>
> Thus, in my view, whether particular arrangements are adequate is to be determined as a question of fact.

If the conflict management obligation applied, Justice Jacobson's reasons suggest, Citigroup's Chinese wall would have satisfied it. Since the firm's arrangements "appear to comply" with the requirements for effective Chinese walls set out by the House of Lords in *Bolkiah* v. *KPMG,*[114] they "would have been adequate for purposes of s912A(1)(aa) of the *Corporations Act*."[115]

The reasons deserve close attention. The passage excerpted above should not be interpreted as meaning that "management" excludes "avoidance" or "elimination" or, put another way, that "eliminating" conflicts is a step beyond the act of "managing" them. Such an interpretation would be contrary to contemporary definitions of the expression "management"[116] as well as to the legislature's apparent intention in enacting the provision.[117] Instead, management of conflicts should be understood to include the notion of avoiding them or eliminating them. Justice

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[114] [1999] 2 A.C. 222.
[115] See *ASIC v Citigroup* at [447] to [452].
[116] According to the *Chambers Dictionary* (Edinburgh, 2000), "management" means the art or act of managing, and the transitive verb "manage" means (selectively) to handle, to conduct, to control, to administer and to deal tactfully with. It seems plausible to suggest that one might handle, control, administer or deal tactfully with a conflict of interest (or a problem, for that matter) by putting an end to it or avoiding it. So, for example, having in place adequate arrangements for the management of problems may well require arrangements that put an end to a problem (by, for example, solving it).
[117] The relevant Explanatory Memorandum indicates that complying with the obligation will encompass "ensuring that there is adequate disclosure of conflicts to investors … [and requiring] internal policies and procedures for *preventing* and addressing potential conflicts of interest that are robust and effective" [emphasis added]. CLERP 9 Explanatory Memorandum, *supra* note 70, at 5.597.

Jacobson expressly acknowledges this earlier in his reasons, stating that “one way of managing conflicts would be to eliminate them”.[118]

It is difficult, however, to reconcile this conception of conflict management with Justice Jacobson’s statement that the statutory obligation “does not require a licensee to take that step [of eliminating conflicts]”[119] as well as the statements in the passage extracted above. But the reasons may best be interpreted in the following way. The statutory obligation requires licensees to have in place adequate arrangements for the management of conflicts of interest. Determining whether arrangements are adequate involves a fact-specific inquiry. In the present case, management of the alleged conflicts did not require Citigroup to eliminate or avoid them. Citigroup’s Chinese walls were adequate arrangements under the statute. Indeed, in many cases Chinese walls meeting certain general criteria may constitute adequate arrangements under the statute. But a conflict of interest may also be managed by avoiding it. And Justice Jacobson was not foreclosing the possibility that, in another case – an extraordinary case perhaps – what will be required by the statute are arrangements that manage the conflict by avoiding or eliminating it.

This interpretation is consistent with the legislative approach of imposing a broad principle – rather than providing specific rules or prescribing or proscribing particular conduct – to regulate licensee responses to conflicts.[120] In addition, the approach does not prejudge the adequacy of the arrangements required in any particular context – a significant consideration in light of the dynamic nature of the investment banking industry.

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[118] *ASIC v Citigroup*, at [311]. The full sentence is “Of course, one way of managing conflicts would be to eliminate them but s912A(1)(aa) does not require a licensee to take that step” [citation omitted]. The latter part of this statement is considered in the text below.
[119] *Ibid.*, at [311].
[120] The regulatory approach has been described as being “principles-based”, involving the imposition of a broad standard of conduct rather than the prescription of specific rules. See CLERP 9 Explanatory Memorandum, *supra* note 70, at para. 5.598 and CLERP 9 Discussion Paper, “Corporate disclosure: Strengthening the Financial Reporting Framework”, at pp. 118-119.

It is also possible to conceive of circumstances in which any conduct of an investment bank falling short of conflict avoidance would be a response so unreasonable that the legislature could not have intended it to satisfy the statutory obligation.[121] Take the example of an investment bank (to which the statutory obligation applies) that is retained by Company X to advise on its proposed acquisition of Company Y, a company known to have entrenched management resistant to ceding control. Could the investment bank simultaneously advise Company Y on its defense? While the duty to protect confidential information would preclude the same individual bankers from also acting for Company Y, it would not prevent a different team within the firm from acting for Company Y where an effective Chinese wall eliminated any real risk of disclosure of confidential information from one team to the other.[122] Ignoring any fiduciary obligations that may exist and assuming the consent of Company X is not obtained (which the company is at liberty to withhold), could this arrangement, or any other arrangement, be considered to manage the obvious conflict for the purposes of the statutory obligation such that the firm could represent both sides on the transaction?

Once advisers learn that their counterparts on the transaction are colleagues (as they inevitably would when the deal is publicly announced), their ability to act vigorously in their client's interests would be compromised and damage would likely result to public confidence in the integrity of financial markets. In these circumstances, the statutory obligation could only require conflict avoidance, meaning that the firm would fail to discharge its statutory obligation by adopting any arrangement other than declining Company Y's instruction. The statutory obligation would amount to little more than an empty legislative gesture were it to permit this state of affairs.

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[121] Part of the discussion in the text following this note is based on Andrew Tuch, "Obligations of Financial Advisers in Change-of-Control Transactions: Fiduciary and Other Questions" (2006) 24 Company & Securities Law Journal 488 at 517 – 518.
[122] See *Bolkiah (Prince Jefri)* v. *KPMG* [1999] 2 A.C. 222, at 237.

It is worth observing that even if the relationship between Citigroup and Toll had been fiduciary in character, the statutory obligation would not have applied to Citigroup. An often-overlooked feature of the case is that an exemption in regulations to the statute applied, with the result that the statutory obligation would not have been engaged whatever the outcome of ASIC's fiduciary claim.[123] It follows that Citigroup had no obligation to avoid conflicts or any obligation to manage conflicts. That an exemption in the regulations should prevent the statutory obligation from applying in this context is an odd state of affairs and seems to be an unintended gap in the regulation of conflicts of interest in the financial services industry. It suggests that, contrary to expectations, investment banks will operate unconstrained in some types of transactions, having no obligation to avoid – let alone manage – conflicts of interest.

For completeness, it is worth observing that Citigroup's mechanisms – comprising a Chinese wall – would have satisfied the statutory obligation had it applied. Chinese walls having the broad characteristics set out by Lord Millett in *Bolkiah* v. *KPMG*[124] "will ordinarily be effective" for managing conflicts of interest.[125] Thus, the regulatory gap did not operate to the detriment of Citigroup's client in this case.

B. Overlap with the duty to protect confidential information

Although brief, Justice Jacobson's remarks on the meaning of the statutory obligation appear to conflate the notions of conflict management and protection of confidential information. In determining whether Chinese walls constitute adequate arrangements for the management of conflicts of interest under the statutory obligation, Justice Jacobson asserts – without explaining why – that one must adopt the "same approach" as adopted by Lord Millett in the House of Lords

[123] See *ASIC v Citigroup*, at [422] to [441], especially at [440].
[124] [1999] 2 A.C. 222.
[125] *ASIC v Citigroup*, *supra* note 1, at 448.

decision in *Bolkiah* v. *KPMG.*[126] Faced with an action by the former client of an accounting firm seeking to restrain the firm from acting on another matter by reason of the firm's possession of confidential information, Lord Millett asserted that the court should intervene to restrain the firm "unless it is satisfied that there is no risk of disclosure [of the confidential information]."[127] In determining whether Chinese walls were effective for this purpose – to satisfy the firm's duty to protect confidential information – Lord Millett referred to the organizational arrangements that Chinese walls will ordinarily involve, which he adopted from a 1992 consultation paper by the UK Law Commission.[128] Lord Millett's reasons demonstrate that these organizational arrangements were relevant to the factual question of whether the firm had eliminated the risk of disclosure, as required by the duty. In *Citigroup*, Justice Jacobson applies this approach, finding that Citigroup's Chinese walls appear to satisfy the organizational arrangements set out in *Bolkiah*.[129] His reasons suggest that Chinese walls, but one technique for managing conflicts, will "ordinarily" be effective to discharge the statutory obligation.[130]

By invoking the so-called *Bolkiah* test for determining the adequacy of Chinese walls, the case sets the bar low for the statutory obligation to manage conflicts. This is because investment banks performing their financial advisory and underwriting functions will typically owe a duty of confidence to their clients and thus, to the extent they possess confidential information, will be obliged to have effective Chinese walls in place for the purpose.[131] If Chinese walls will

[126] *ASIC v Citigroup*, at [318].
[127] [1999] 2 A.C. 222 at 237.
[128] *Ibid.*, at 238, citing "Fiduciary Duties and Regulatory Rules 1992 Paper", [4.5].
[129] *ASIC v Citigroup*, *supra* note 1, at [449] to [452].
[130] Jacobson J. explains that "in *Bolkiah,* Lord Millett referred to Chinese walls as a technique for managing conflicts of interest and he described the types of organizational structures that would ordinarily be effective" (at [448]). It is unclear where Lord Millett refers to these organizational structures as ordinarily being effective. Moreover, Lord Millett's inquiry concerns the effectiveness of Chinese walls for satisfying the duty of confidence, rather than their effectiveness as an arrangement for managing conflicts of interest.
[131] The relationship between an investment bank and its financial advisory client is a situation where this duty of confidence arises: this is implicit in the decision of *Mannesman AG* v. *Goldman Sachs International* (unreported, High Court of Justice of England and Wales, Chancery Division, Lightman J., 18 November 1999).

ordinarily be effective to satisfy the statutory obligation, the statute ordinarily requires nothing more of firms than the separate duty of confidence requires.

Invoking the *Bolkiah* test is a surprising approach for other reasons. First, the test is directed towards protecting confidential information, rather than managing conflicts of interest. Second, where a client cannot identify relevant confidential information – but may nevertheless be able to point towards a conflict of interest – it is unclear how the *Bolkiah* test should be applied. These reasons add weight to the view that the judgment leaves open the possibility that other arrangements for managing conflicts may be required to satisfy the statute, including arrangements to avoid or eliminate conflicts.

As to when conflict management will require the licensee to avoid conflicts, the author has argued elsewhere that courts must have regard to fiduciary doctrine in answering this question.[132] More specifically, the statutory obligation requires conflict avoidance where fiduciary doctrine imposes that obligation – where, on the facts, a fiduciary relationship exists between the licensee and its client such that the licensee is obliged to avoid positions of conflict.[133] Arrangements adequate for conflict management in this situation will be those that, absent informed consent, put an end to the conflict.[134] Still, beyond this suggested guidance, the contours of the obligation still need to be mapped out and further questions must be answered. One question is whether the expression “conflicts of interest” is restricted to those circumstances that would constitute conflicts in equity (being those circumstances that would breach the fiduciary obligation to avoid conflicts) or might capture broader situations. The *Citigroup* case leaves this question open.

VI. Conclusion

[132] Andrew Tuch, “Obligations of Financial Advisers in Change-of-Control Transactions: Fiduciary and Other Questions”, (2006) 24 Company and Securities Law Journal 488 at 519.
[133] *Ibid*.
[134] *Ibid*.

This essay has described the conglomerate structure of the modern investment bank and the incidence of conflicts of interest in the industry. It has classified common conflicts in the industry and discussed the situations in which fiduciary constraints will typically arise. Against the backdrop of the Federal Court's decision in *ASIC v Citigroup*, the essay has discussed the extent to which the classic fiduciary obligation to avoid conflicts is informed by the co-existence of a statutory obligation to manage conflicts as well as the meaning of the expression *conflict management*.

The decision in the case represents a triumph for Citigroup. Citigroup owed Toll neither a fiduciary obligation to avoid conflicts nor a statutory obligation to manage conflicts. Its conduct met the standard required by both obligations – no conflicts of interest were proved and, even if they had been, Citigroup's conflict management arrangements were adequate. Its client implicitly consented to the alleged wrongdoing in any case.

The decision also provides guidance for the regulation of conflicts in the industry, but inevitably leaves important questions without firm answers. If not for an exclusion clause in an engagement letter signed early in the advisory process, an investment bank runs the real risk of owing the fiduciary obligation to avoid conflicts of interest. That obligation is not diluted or otherwise attenuated by regulatory recognition of the multifarious activities conducted by such a firm. There is nothing notorious about an investment bank's proprietary trading operations, and these operations are not inherent in the investment banking business. If a fiduciary relationship exists, the investment bank must avoid conflicts outright within the scope of the relationship. Even where fiduciary obligations are excluded, the statutory obligation may apply. It will not always be satisfied by an investment bank's Chinese walls, however robust, but may require the firm to avoid or eliminate the conflicts in question.

The decision raises difficult issues for courts, policy makers and others concerned with the integrity of the financial system. It reveals a paradox in financial services regulation: under general law an investment bank may owe obligations of loyalty that are incompatible with its organizational structure. Contractually excluding the obligations is a workmanlike response to the puzzle, but does not solve it. The response invites criticism since it suggests that the activities of some firms depend on their requiring clients to forgo protections the law would otherwise provide. The response is vulnerable to decisions of appellate courts, which may articulate as yet unrecognized limits on the extent to which fiduciary obligations may be contractually displaced. Some clients will grow resistant to exclusion clauses. If investment banking conflicts are associated with the next wave of corporate scandals, policy makers will wade in again. Investment banks may yet be required to conform to notions that historically have underpinned the industry.