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Investment Banking: Immediate Challenges and Future Directions

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A recent federal court action brought by the Australian Securities and Investments Commission against the world's largest financial services group has refocussed attention on conflicts of interest in investment banking and comes at a time of rapid industry change.[1] This article provides a brief historical perspective of the nature of investment banks and the incidence of conflicts of interest, describes the relevant regulatory framework and some of the questions raised by the legal proceedings, outlines observable trends in the industry, and discusses the more pressing issues facing the industry. Although the litigation will test Australian law, the consequences of it and the focus of this article are international in scope.

The nature of investment banking and the potential for conflicts

The term 'investment bank' is applied to an organisation that performs certain specialised financial intermediary functions. Coined in the United States early last century, the expression may be a misnomer in Australia since the firms typically do not perform the banking functions of accepting deposits and making loans to the retail public. In an earlier time, they were also commonly known as merchant banks or money market corporations.[2]

The forebears of investment banks were great banking dynasties, formed around powerful American and European families such as JP Morgan, Lehman, Rothschild and Warburg. Then investment banks fulfilled the role of close confidant and trusted advisor to corporate management, being valued for their financial markets knowledge and business acumen; they continue to perform this role today. Indeed, the ability to advise top corporate management is seen as a measure of a firm's connections and influence, which are greatly prized in the industry.[3]

The traditional investment banking functions are securities underwriting and corporate advisory services.[4] Securities underwriting involves the firm underwriting — or assuming risk associated with — the issue of debt or equity securities by companies. Generally speaking, corporate advisory services, sometimes also referred to as financial advisory services or corporate finance, involve advice to corporate management in transactions of strategic significance, such as mergers and acquisitions (M&A) and restructurings.[5]

In response to the internationalisation of capital markets, regulatory changes and client forces, many investment banks in recent decades have supplemented these traditional functions with myriad other financial products and services. These include securities and derivatives trading on behalf of clients, investment research, financing, asset management, equities and derivatives trading on the firm's own account (also known as proprietary trading) and principal investments (such as private equity operations).[6] Leading examples are Goldman Sachs, Merrill Lynch and Morgan Stanley.[7] In a related trend, major commercial banks began venturing into traditional investment banking territory, by buying and building investment banking divisions.[8] Citigroup, Deutsche Bank and UBS exemplify this development.[9]

As the industry has consolidated these firms have grown significantly in size and expanded their global reach. They are now often referred to as integrated investment banks, financial services conglomerates or global investment banks and represent concentrations of vast economic power, offering multiple products and services to a substantial number of clients in major financial centres worldwide. This description of their business structure is necessarily general, and different firms will offer a different range of services and their units will function with varying degrees of operational autonomy.

A consequence of this evolution is that opportunities — and perhaps also incentives — exist for an investment bank to prefer the interests of one client over those of another or even to prefer its own self-interest. In their regulatory filings, many investment banks acknowledge the increased risk of conflict created by their organisational structure.[10] Indeed, it has been said that conflicts of interest are an inevitable consequence of the integrated business model and may be inherent in it.[11] A conflict of interest arises where an investment bank is in the position where a conflict or overlap exists between the interests of its client, on the one hand, and either its self-interest or the interests of another client, on the other hand.

As *The Economist* recently said of one integrated investment bank — controversially perhaps:

'… [the investment bank] now finds itself on so many sides of a deal simultaneously that the mind boggles. [Its] [private equity] arm competes with clients (and counts them as customers), and its proprietary arm may trade against 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.'[12]

It has been suggested, however, that this business structure is a response to client needs and that 'it can be the very expertise which attracts a customer to a firm that may create the potential for conflicts to occur'.[13]

Even so, the incidence of conflicts of interest in investment banking has provoked widespread political and regulatory concern in recent years. Following the dotcom frenzy in the United States at the turn of this century, attention focussed on research analyst conflicts — the conflict between interests of potential investors to whom independent research reports about companies were provided and firms' self-interest in generating lucrative underwriting and corporate advisory engagements from the same companies. Egregious examples of investment banks skewing their research reports in an attempt to generate underwriting or advisory business garnered international attention.[14] At this time, traditional investment banking services represented a substantial source of revenue for major investment banks, and this allegedly provided an incentive for the behaviour. The conduct, in turn, reflected the adage that the M&A tail wags the investment banking dog.[15]

The intervening period — the past few years — has seen a pronounced shift in both the revenue drivers of many integrated investment banks and, correspondingly, the apparent focus of regulators. Today, much of total investment banking revenue comes from sources outside a firm's traditional investment banking activities.[16] In particular, the functions of proprietary trading and principal investing assume greater significance.[17] For example, in 2005 Goldman Sachs earned 15 per cent of its total revenue from traditional investment banking activities, compared with 66 per cent from trading and principal investments.[18] Merrill Lynch's second-quarter results for 2006 show that it earned nearly as much from running its private equity funds as it did from traditional investment banking functions.[19] In a further sign of the times, Morgan Stanley recently announced that it had formed what it referred to as an 'all star' team of dozens of bond traders to trade exclusively on the firm's account[20] and also that it would be resuming its private equity operations, which it had divested in 2004 amid concerns about conflicts of interest.[21]

Although traditional investment banking services remain lucrative (especially for investment bankers themselves) there has been a corresponding diminution in the importance of this work to the integrated firms.[22] It is interesting to observe that while the value of M&A for the first six months of 2006 averaged over US$10 billion per day — the highest ever recorded[23] — investment banking fees were significantly lower than for the corresponding period in 2000 during the technology boom.[24]

The contemporary regulatory agenda reflects these developments. ASIC's current focus — which is shared by its United Kingdom counterpart, the Financial Services Authority[25] — appears to be on the potential conflict between the interests of (or a duty owed to) corporate advisory clients and a company's self-interest in proprietary trading. In a recent speech, a managing director of the FSA explained that '[t]he more that investment banks make money from buying and selling securities on their own account rather than from traditional investment banking activities, the more potential there is for conflicts of interest to arise and possibly be abused'.[26] Whereas five years ago investment banks stood accused of sacrificing retail client interests at the altar of corporate advisory interests, today it is the interests of corporate advisory clients that apparently need protection from the self-interested conduct of investment banks.

The last few years have also seen the growing prominence of independent financial advisory firms, in Australia and abroad. These firms typically focus on the traditional investment banking functions, particularly the provision of corporate advisory services, and are regularly seen advising on the highest profile transactions. They are 'frequently being called into big deals by CEOs seeking a counterpoint to the advice of integrated firms'.[27] According to Thomson Financial, a research firm, independent advisory firms advised on 55 per cent of the 20 largest merger transactions announced in 2005.[28] Their business structure, which diminishes the prospect of conflicts arising, has been suggested as a reason for this trend.[29] At the same time, contrary to perceptions, some independent firms can match the scale of corporate advisory services of the integrated investment banks.[30] Prominent examples of these firms include New York-based Greenhill & Co and, in the Asian region, Australia's Caliburn Partnership.

It is interesting to observe that, like integrated firms, some so-called independent advisory firms have also succumbed to the temptations of principal investing, with the result that they now have both advisory arms and private equity arms. Accordingly, just as it would be wrong to assume that a firm wearing the independent advisory label is small compared with the advisory units of integrated banks, it would be wrong to assume that this business model generates no temptations for client disloyalty.

Recent regulatory focus on research analyst conflicts of interest

Before turning to the Australian regulatory regime, it is instructive to consider the incidence of research analyst conflicts during the recent dotcom boom. The US experience, alluded to above, is well known: investigations launched in early 2002, including by the New York State Attorney General Eliot Spitzer, disclosed systemic conflicts in investment banking and resulted in a landmark settlement in April 2003. In the wake of these events, the Australian financial regulator assessed the incidence in this market of this type of conflict of interest.

In its report released in August 2003, ASIC explained that it reviewed the activities of research analysts at eight investment banks in Australia for the purpose of 'a campaign to examine [their] independence'.[31] Although it found that there was 'an unreasonable level of reliance by investment banks on their staff both to identify and then manage and disclose [conflicts]', ASIC concluded as follows:

'It is important to say that generally the review has not identified the same corporate failings or misconduct as had occurred in the USA, nor did it indicate that any of the misleading selling practices being investigated in the USA are present domestically.'[32]

This conclusion has often provided a basis for contrasting the Australian experience of investment banking conflicts with the United States' experience. For example, it provided an explicit basis for the Chief Executive Officer of the Australia Stock Exchange to assert that the issue of research analyst conflicts 'has not been an area for misconduct in Australia,' which 'reflects well on those who operate in our markets'.[33] A reason cited for this was that 'companies, in Australia, have ethical cultures and reflect that culture when appointing [investment banks]' which are, in turn, conscious of the need for untainted reputations.[34]

In fact, the eight investment banks in the review faced nothing like the intrusive scrutiny that their US counterparts did, and ASIC's report says nothing about whether, at the time of the reported abuses in the US, similar — or different — practises were occurring in Australia. The report acknowledged that whereas US regulatory authorities 'specifically selected an earlier period for review and investigation prior to … enhanced compliance procedures [being] implemented in 2002', ASIC focussed on existing procedures, even though by that time many investment banks had revised them in light of the earlier US regulatory action.[35] Given that ASIC's review was limited to a period largely subsequent to the US investigations and rule changes, its conclusion is hardly surprising.

Regulatory framework in Australia

In response to what was referred to in the CLERP 9 reform process as 'a general unease in Australia about … the management of conflicts of interest when providing financial services'[36] the federal legislature introduced into the Corporations Act 2001 (Cth) the statutory obligation on financial services licensees, which include investment banks, to have in place adequate mechanisms for the management of conflicts of interest.[37] Introduced with effect from January 1, 2005, the obligation supplemented the existing statutory duty on licensees to provide financial services 'efficiently, honestly and fairly', which is also considered to impose some form of conflict response obligation on investment banks.[38]

ASIC was tasked with sending a strong message on conflicts, which the parliamentary committee reviewing the reforms said that the new statutory conflict management obligation failed to do.[39] In taking up that challenge, ASIC released Policy Statement 181, which sets out its 'general approach to compliance with the statutory obligation to manage conflicts'.[40] According to the statement, arrangements to manage conflicts will be 'measures, processes or procedures' that control, avoid or disclose conflicts[41] and will depend on the nature, scale and complexity of the licensee's business.[42] ASIC asserts that many conflicts of interest may be managed by a combination of internal controls and disclosures,[43] but that other conflicts 'have such a serious potential impact on a licensee or its clients that the only way to adequately manage [them] will be to avoid them'.[44] In the latter case, merely disclosing conflicts, imposing internal controls or adopting Chinese walls will not discharge the statutory obligation.[45]

It appears from ASIC's stance in the federal court proceedings that such a serious conflict exists when an investment bank providing corporate advisory services to a client is also undertaking proprietary trading in a way inconsistent with that client's interests. The conflict is thus between the interests of (or a duty owed to) a firm's corporate advisory client and its self-interest. In fact, ASIC also asserts that the relationship can be fiduciary in character, such than an obligation to avoid conflicts of interest arises.[46] A consequence of this is that Chinese walls between the advisory and trading units of a firm may be ineffective to prevent the conflict arising.[47] Leaving aside the question of informed consent, it follows that the investment bank in this context — providing corporate advisory services to a client on a strategic transaction — is faced the stark choice of either terminating the corporate advisory engagement or not trading on its own account in a way inconsistent with its client's interests.

In its policy statement, ASIC asserts that the fiduciary obligation co-exists with the statutory obligation,[48] but what this means in practice is clearly something with which investment banks have struggled.

These issues do not directly concern confidential information, which is protected separately (outside statute and fiduciary doctrine) by the duty of confidence. The competence of investment banks in providing these services is also not in issue. Instead, the focus is on the degree of loyalty — of faithful service — that investment banks must give in certain contexts.

Other observable industry trends

Two further industry trends are observable. The first relates to the riskiness of the business of integrated investment banking. This reflects the growing importance to integrated firms of proprietary trading and private equity operations. In general terms, some investment banks are taking riskier positions and so face the prospect of losing significantly greater sums of money than they did in the past. Indeed, this trend, which has fuelled record profits of major investment banks in recent years, has been described as 'the biggest game of risk ever to play out on Wall Street'[49] and is reflected in the 'value at risk' statistic disclosed by many firms.[50] Goldman Sachs has been described as 'a hedge fund with an investment bank stuck on'.[51] Whether or not this description is accurate, the admiration and copy-cat strategies it has inspired are curious. Some might remember the similar description given to another company, infamous for its demise, as 'more of a hedge fund than an energy company'.[52]

The second trend is the heightened sensitivity of various parties to investment banking conflicts. Take as an example the reported decision of Industrial & Commercial Bank of China to drop an investment bank from underwriting its proposed initial public offering (IPO) after the investment bank was selected to underwrite the IPO of one of the bank's competitors. This was seen as an indication of the investment bank's concern 'to avoid any perception of conflicts of interest among their [underwriters]'.[53] Similarly, after being much criticised for engaging a conflicted investment bank to advise it in its merger with Archipelago, the New York Stock Exchange is reported to have carefully avoided giving that firm major roles in subsequent transactions.[54]

Shareholders are also sensitive, as evidenced by recent United States litigation in which shareholders have brought derivative actions alleging that directors breached their duty of care to the company by engaging an investment bank which was in a position of conflict with the company's interests.[55] Perhaps this explains the growing vigilance of corporate management. Courts have shared this concern. In *In re Toys 'R' Us, Inc, Shareholder Litigation*,[56] the Court of Chancery of Delaware was critical of directors of Toys 'R' Us, which was being bought-out by a consortium of private equity funds, for permitting its financial adviser to provide funding to the consortium, even though the merger agreement had already been executed. While the directors had not breached their fiduciary duties in doing so, the practice — of a sell-side adviser providing finance on the buy-side of a deal — 'tends to raise eyebrows by creating the appearance of impropriety, playing into already heightened suspicions about the ethics of investment banking firms,' the court said.[57]

Investment banks themselves appear careful to avoid the perception of conflicts.[58] Some integrated investment banks have spun off business units in order to diminish the prospect of conflicts.[59] Others have voluntarily withdrawn from transactions citing concerns over perceived conflicts: witness the withdrawal of an investment bank as adviser to the Nasdaq in its proposed transaction with the London Stock Exchange.[60] At the same time, the lure of profits from activities such as proprietary trading and private equity operates as a powerful counter-force to the sensitivities of investment banks to conflicts of interest.[61]

Pressing issues facing the industry

Against this backdrop of rapid industry change, a number of pressing issues confront financial regulators and investment banks. This article concludes by offering brief observations on a number of them.

To begin with an obvious question: precisely why should financial regulators concern themselves with conflicts of interest in investment banking? ASIC has suggested that conflicts of interest risk diminishing public confidence in the financial system and 'pose a threat to investor protection'.[62] Conflicts may also undermine the integrity of advice or services provided[63] and thus damage the interests of investment banking clients that turn to these firms for advice. It may also be that the economic power wielded by investment banks is reason enough for regulators to keep an eye on them.

The question of how and to what extent conflicts in investment banking should be regulated is a more contentious issue. Under the Australian regulatory regime — consisting of a statutory obligation, supplemented by policy guidance from ASIC — investment banks have primary responsibility for deciding how to respond to conflicts of interest. Two points can be made. First, the statutory obligation imposes a broad standard of conduct, rather than prescribing or proscribing specific conduct, and, as one would expect for a dynamic industry like investment banking, ASIC's policy statement does not provide concrete guidance on how the obligation applies to the full range of conflict situations.[64] Second, the regime is self-regulatory in the sense that individual firms adopt their own conflict-response arrangements without (apparent) regular oversight or monitoring by the financial regulator. This characteristic of the regime is unsurprising, and perhaps even desirable, in view of the burdens that regulatory oversight would impose on both investment banks and the resource-constrained regulator.

It must be acknowledged, however, that a regime that relies for its effectiveness on the integrity of the firms regulated (which in turn rely on the personal integrity of those they employ) may not inspire public confidence. This would be an unreasonably harsh observation if relatively recent events had not impugned the integrity and tarnished the reputations of investment banks in the public consciousness.

Perhaps the most pressing question confronting the industry is what the conflict management obligation actually requires. Can all conflicts be managed by using measures such as Chinese walls or must some conflicts be avoided outright? So, for example, when an investment bank is engaged to provide corporate advisory services to a bidder in a proposed takeover, should the investment bank avoid any real and sensible possibility of conflict with the interests of that client? In other words, are corporate advisory clients entitled to the loyal service of their interests or is it naïve to expect loyalty from organisations that are 'designed to maximise the fee take rather than provide devoted attention to any one client'?[65]

For reasons explained by the author elsewhere,[66] the statutory conflict management obligation should be interpreted to require investment banks, as financial services licensees, to avoid positions of conflict in some situations. This interpretation is supported by the Explanatory Memorandum for the CLERP 9 Act[67] and appears to reflect best practice in other jurisdictions.[68]

A related issue is the role of fiduciary doctrine in this analysis. It has been argued that, in the context of corporate advisory services, the relationship between an investment bank and its client is fiduciary in character such that the obligation to avoid conflicts of interest exists.[69] This question, will also be considered in the federal court proceedings referred to above.

There is also the difficult question of whether, like the fiduciary obligation, the statutory obligation can be contractually attenuated or displaced by the parties. However, unless such a contractual mechanism can be considered an 'arrangement' for purposes of the statute, it is unlikely that the statutory duty could be so limited since a contract will not limit an obligation imposed by statute without legislative authority.[70]

A further question is whether the integrated or conglomerate structure of many investment banks ought to be considered in interpreting the conflict management obligation. Should regulators simply accept that the business model makes some conflicts unavoidable? While the commercial context will necessarily be relevant to applying the obligation, courts will be cautious in moulding the content of the obligation to the contours of firms in such a rapidly changing industry.

Now to the sensitive topic of proprietary trading and principal investing: what limits should there be on a firm's ability to engage in these activities? The Corporations Act 2001 (Cth) requires persons who carry on 'financial services business' in Australia to 'have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to ... the provision of financial services'.[71] Proprietary trading and principal investing are outside the scope of the statutory obligation since they do not involve the provision of 'financial services' under the statute.[72] However, they will be caught by the statutory obligation if they are implicated in conflicts involving aspects of an investment bank's activities that are within its financial services business — because the conflict will then be considered to arise 'partially' in relation to financial services activities.[73] It follows that a firm will have no obligation to manage a conflict of interest between a duty owed to (or the interests of) a corporate advisory client and its self-interest in proprietary trading, unless the provision of corporate advisory services is part of the firm's financial services business for purposes of the statute.[74]

A sedate response to all the excitement about conflicts in investment banking (and an answer to many of the questions raised above) is that markets will discipline any errant behaviour by investment banks. After all, isn't it true that 'how [investment banks] handle… conflicts determines how long they will keep clients'?[75] A pragmatic reply is that this appeal to the law of the jungle would not appease the Senator Sarbanes of this world or those who regard many conflicts of interest as being hidden from the view of clients.

Finally, and perhaps of most significance to investment banks, what are client perceptions of investment banking conflicts? What particular conflicts do clients worry about, why do they worry, and what degree of concern do they have? It may be that the future prospects of independent financial advisory firms are intertwined with the answers to these questions.

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1 *Australian Securities & Investments Commission v Citigroup Global Markets Australia Pty Ltd,* Federal Court of Australia (NSD 651/ 2006)

2 A similar development has occurred in the United Kingdom: the Investment Banking Association was formerly known as the British Merchant Banking Association. See UK Law Commission, Fiduciary Duties and Regulatory Rules (1995) Report No. 236, 124.

3 Charles Geisst, *Investment Banking in the Financial System* (1995), 200.

4 Ibid, 2.

5 See, eg, Morgan Stanley Form 10-K (Annual Report) for the fiscal year ended November 30, 2005, filed with the United States Securities and Exchange Commission (hereinafter referred to as the Securities and Exchange Commission), 3-4. See also Andrew Tuch, 'Obligations of financial advisers on change-of-control transactions: fiduciary and other questions' (2006) 24 *Company & Securities Law Journal* 488, 491-494.

6 See, eg, The Goldman Sachs Group, Inc Form 10-K (Annual Report) for the fiscal year ended November 25, 2005, filed with the Securities and Exchange Commission, 4-12; Morgan Stanley Form 10-K (Annual Report) for the fiscal year ended November 30, 2005, above n5, 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, 486.
Investment research involves providing fundamental research on companies, industries, economies, currencies, commodities, and portfolio and quantitative strategy. See The Goldman Sachs Group, Inc Form 10-K (Annual Report) for the fiscal year ended November 28, 2003, filed with the Securities and Exchange Commission, 12.
Forms of finance provided include project finance, infrastructure finance, structured finance, syndicated loans, securitisation, corporate lending, leasing and trade finance: International Banks and Securities Association of Australia, Economic and Social Impacts of Investmnt Banking in Australia (2004), 1

7 See Philip Augar, *The greed merchants: How the investment banks played the free market game* (2005), 30, 37-39.

8 Ibid, 31.

9 Ibid.

10 See, eg, The Goldman Sachs Group, Inc Form 10-K (Annual Report) for the fiscal year ended November 25, 2005, above n6, 23 ('As we have expanded the scope of our business and our client base, we increasingly have to address potential conflicts of interest, including those relating to our proprietary activities.')

11 As to conflicts being inevitable or inescapable, see Royston Goode, *Conflicts of Interest in the Changing Financial World* (1986) xv; UK Law Commission, 'Fiduciary Duties and Regulatory Rules' (1992) Consultation Essay No 124, [1.1], [2.2] and [3.1]; Deborah A DeMott, *Fiduciary Obligation, Agency and Partnership: Duties in Ongoing Business Relationships* (1991) 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.

12 See 'Goldman Sachs: Behind the brass plate', *The Economist*, April 29, 2006, 69 at 70. The term 'private equity' has been substituted for the expression 'merchant banking' since in Australia 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'.

13 Hector Sants, 'Market abuse and conflicts of interest: The FSA approach', Speech to The Financial Crime Forum Asia Pacific, Hong Kong, June 5, 2006 (Mr Sants is Managing Director, Wholesale & Institutional Markets, (UK) Financial Services Authority).

14 In the United States, an investigation initiated by New York Attorney General Eliot Spitzer found that analysts at one major investment bank had consistently skewed their research reports and stock recommendations in an effort to generate investment banking business for the firm. See Press Release, Office of New York State Attorney General Eliot Spitzer, 'Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interests' (April 8, 2002), available at www.oag.state.ny.us/press/2002/apr/apr08b_02.html (at March 31, 2005). For a discussion of the settlement between the New York State Attorney General and that investment bank, including the reforms and disclosures agreed to by the firm as a form of self-regulation, see Jill E Fisch and Hillary Sale, 'The Securities Analyst as Agent: Rethinking the Regulation of Analysts' (2003) 88 *Iowa Law Review* 1035.

15 See Samuel Hayes and Philip Hubbard, *Investment Banking: A Tale of Three Cities* (1990), 131.

16 It has been suggested that '[h]istorically low interest rates and relatively calm markets in the last few years have allowed a new type of firm to flourish, one that acts primarily as a trader and only secondarily as a traditional investment bank, underwriting securities and advising on mergers'. Note also that '… many investment banks now do more trading than all but the biggest hedge funds' and '[w]hat's more, [investment] banks are jumping into the realm of private equity, spending billions to buy struggling businesses as far afield as China that they hope to turn around and sell at a profit. With $25 billion of capital under management [Goldman Sachs'] private equity arm itself is one of the largest buyout firms in the world …'. See, Emily Thornton, et al, 'Inside Wall Street's Culture of Risk', *Business Week Online*, June 12, 2006. See also Steve Rosenbush, 'Investment Banks Jockey for Poition', *Business Week Online*, June 30, 2006 (reporting that trading operations are providing a rising share of bank's profits).

17 Ibid.

18 See The Goldman Sachs Group, Inc Form 10-K (Annual Report) for the fiscal year ended November 25, 2005, above n6, 5. See also Jacqueline Simmons and Julia Werdigier, 'Rohatyn, Altman Lead Bespoke M&A in Record Grab on Wall Street', Bloomberg, March 13, 2006 and 'Goldman Sachs: Behind the brass plate', *The Economist*, April 29, 2006, 69.

19 Ben White, 'Private equity primes Merrill', *The Australian*, July 20, 2006, 20. Although Merrill Lynch did not specify its second-quarter revenue from private equity operations (only that it had increased threefold from the second quarter the previous year), it was estimated by an analyst as US$700 million. This compares to investment banking revenue for the same period of US$978 million.

20 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 the 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).

21 See Andrew Sorkin, 'Morgan Stanley Jumps Back into Private Equity', *New York Times DealBook* (September 26, 2006); Morgan Stanley, 'Morgan Stanley Appoints Stephen Trevor and Alan Jones as Co-Heads of Newly Established Private Equity Business Within its Asset Management Division', Press Release (September 26, 2006); Julia Werdigier and Dana Cimilluca, 'Morgan Stanley Risks M&A Fees by Emulating Goldman Sachs's LBO's' Bloomberg.com (October 9, 2006).

22 See above n16. But compare Malcolm Maiden, 'Touche: bankers thrust and parry', *The Age*, June 3, 2006 (the following comment is attributed to Alastair Lucas, '… it's absolutely true that the investment banking share of the revenue [of an integrated investment bank] tends to have fallen. But it's also true that the absolute amount of investment banking income has grown, and there's been no decline in the global market share of investment banking of both UBS and Goldman [Sachs] over the last decade[;] in fact, both have increased market share.')

23 According to Dealogic, global deal volume for the first six months of this year was US$1.93 trillion — the highest half-year volume on record: Steve Rosenbush, 'Investment Banks Jockey for Position', *Business Week Online*, June 30, 2006.

24 Ibid. (Dealogic reports that 'investment banking revenue' for the first six months in 2006 was US$7.26 billion compared with US$10.6 billion for the comparable period in 2000).

25 See comments by Hector Sants, 'Market abuse and conflicts of interest: The FSA approach', above n13.

26 Ibid.

27 Philip Augar, above n7, 32.

28 'Boutique banks: Niche market', *The Economist*, August 26, 2006, 58. According to a Goldman Sachs report, the market share of global mergers and acquisitions advisory work of independent advisory firms increased from just 10 per cent in 1994 to 25 per cent: Jacqueline Simmons and

Julia Werdigier, 'Rohatyn, Altman Lead Bespoke M&A in Record Grab on Wall Street', Bloomberg, March 13, 2006.

29 See, eg, Malcolm Maiden, 'Touche: bankers thrust and parry', *The Age*, June 3, 2006 (the following statement is attributed to Mr Peter Hunt of Caliburn Partnership, an independent advisory firm, 'Now when we market, we don't have to explain conflict, because clients are concerned about conflicts within integrated banks before we walk in, and that has given a spurt to our business, which was already growing'.)

30 Ibid.

31 Australian Securities and Investments Commission ('ASIC'), 'Research analyst independence: ASIC surveillance report', August 22, 2003 ('ASIC Surveillance Report'), para 1.4.

32 Ibid, paras 1.7 and 6.4.

33 Tony D'Aloisio, 'Conflicts of interest for analysts' (comments in response to a paper by Professor Jill Fisch), Corporate Law Teachers Association Conference, Sydney, February 7, 2005. Available at www.asx.com.au/about/pdf/ConflictsBrokers070205.pdf (as at December 4, 2006))

34 Ibid.

35 ASIC Surveillance Report, above n31, para 1.8. See also para 1.11 (observing that the review was conducted in two stages and that many concerns identified during the first stage 'had been corrected before the stage 2 visits had commenced'). By contrast, for example, the investigation by the New York State Attorney General examined investment bank practices at least back to 1999: Miles Costello, 'Why should we trust analysts ever again?', *Mail on Sunday*, April 14, 2002, C1.

36 The Parliament of the Commonwealth of Australia, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 Explanatory Memorandum, para. [5.594].

37 Section s912A(1)(aa) of the Corporations Act 2001 (Cth) provides that a financial services licensee must 'have in place adequate arrangements for the management of conflict of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business of the licensee or the representative'.

38 Corporations Act 2001 (Cth), s912A(1)(a). As to its application to conflicts of interest, see Commonwealth of Australia, Report by the Parliamentary Joint Committee on Corporations and Financial Services on CLERP (Audit Reform and Corporate Disclosure) Bill 2003, June 2004, para 9.13; *Story v National Companies and Securities Commission* (1988) 13 NSWLR 661 at 672 ('[T]he group of words "efficiently, honestly and fairly" must be read as a compendious indication meaning a person who goes about their duties efficiently having regard to the dictates of honesty and fairness, honestly having regard to the dictates of efficiency and fairness, and fairly having regard to the dictates of efficiency and honesty.')

39 The conflict management obligation was acknowledged by The Parliamentary Joint Committee on Corporations and Financial Services — which reviewed the CLERP 9 legislation — as failing to deliver a strong message that certain conflicts would not be tolerated. The committee observed that ASIC was left with the task of delivering that strong message. See Commonwealth of Australia, Report by the Parliamentary Joint Committee on Corporations and Financial Services on CLERP (Audit Reform and Corporate Disclosure) Bill 2003, June 2004, para 9.26.

40 ASIC, 'Licensing: Managing conflicts of interest', Policy Statement 181 (2004), 1.

41 Ibid [PS 181.20].

42 Ibid [PS 181.10].

43 Ibid [PS 181.10]-[PS 181.11], [PS 181.20], [PS 181.27].

44 Ibid, [PS 181.42].

45 Ibid [PS 181.42].

46 This question has not been directly addressed by courts, but see cases discussed in Andrew Tuch, 'Investment Banks as Fiduciaries: Implications for Conflicts of Interest', above n6, at 491-497.

47 Chinese walls may be effective to prevent what would otherwise be a breach of the duty of confidence (*Prince Jefri Bolkiah v KPMG* (a firm) [1999] 2 AC 222 at 237) but may not prevent a breach of the fiduciary duty to avoid conflicts of interest. See, eg, Law Commission, United Kingdom, 'Fiduciary Duties and Regulatory Rules' (1995) Report No 236 at [2.16] and [7.15].

48 See ASIC, 'Licensing: Managing Conflict of Interest', above n40, [PS 181], [PS 181.5], [PS 181.19].

49 Emily Thornton, et al, 'Inside Wall Street's Culture of Risk', *Business Week Online*, June 12, 2006.

50 See, eg, 'Goldman Sachs: Behind the brass plate', *The Economist*, April 29, 2006, 69, 70.

51 Oliver Morgan, 'Wall Street's inscrutable titan takes a tumble', *Observer*, June 11, 2006.

52 See, eg, Michael Schroeder, 'Enron: The fallout: Firm's downfall raises concern over derivatives — US law makers push for more oversight', *The Asian Wall Street Journal,* January 29, 2002.

53 'Citic Bank Hires Arrangers for $2 Bln Hong Kong IPO (Update 2)', Bloomberg.com, May 26, 2006; see also Tom Bawden, 'Merrill Lynch misses out in flotation of Chinese bank', *Times Online*, April 14, 2006.

54 Goldman Sachs was not provided with lead underwriting or financial advisory roles on, respectively, the NYSE's secondary offering of securities or its proposed business combination with Euronext.

55 For example, in *Higgins v New York Stock Exch, Inc* 10 Misc.3d 257 (2005) aggrieved shareholders of one of the companies alleged that directors breached their duties to the company by approving the retention of the investment bank to provide corporate advisory services. The shareholders alleged that 'the directors were aware that [the investment bank] was simultaneously providing services to [the other company] from the engagement letter, and further due diligence would have revealed the extent of [the investment bank's] stock holdings in [that company]'. (at 285).

56 877 A.2d 975 (2005) (Court of Chancery of Delaware). Shareholders alleged that directors had breached their fiduciary duties to the company in the course of arranging for the sale of the company to a consortium of private equity funds. After the company had entered into the merger agreement, it acceded to the request of its financial adviser to provide financing 'on the buy-side' for the consortium. In addition to the decision 'raising eyebrows' (discussed in the text above), Judge Strine asserted as follows: 'Far better, from the standpoint of instilling confidence, if First Boston had never asked for permission, and had taken the position that its credibility as a sell-side advisor was too important in this case, and in general, for it to simultaneously play on the buy-side in a deal when it was the seller's financial advisor. In that respect it might have been better, in view of First Boston's refusal to refrain, for the board of the Company to have declined the request, even though the request came … almost two months after the board had signed the merger agreement.' (at 1006).

57 877 A.2d 975 (2005) at 1006.

58 See, eg, Avital Louria Hahn, 'I-banks pull back from stapled financing: Legal scrutiny of potential conflicts and easy debt markets cut number of offers', *Investment Dealers Digest,* April 3, 2006; Bryce Elder, 'Goldman Sachs backs away from hostile takeovers', *Times Online,* April 18, 2006.

59 In 2006 Merrill Lynch spun off its asset management arm BlackRock inc and in 2005 Citigroup swapped its asset management business for a brokerage business: see Herbert Lash, 'Wall Street funds spin-offs signal end of big dream', Reuters, February 14, 2006 ('One-stop shopping is a great business idea that never flew in asset management, which is driving Merrill's deal with BlackRock and will Morgan Stanley, Wachovia Corp. and Bank of America to shed their mutual funds [according to one observer]'). These transactions are designed to remove a conflict of interest from the investment banks: see Michael Martinez 'Merrill Lynch to combine with BlackRock', *Canoe Money*, February 15, 2006 ('Citigroup and Merrill are avoiding the potential for conflicts of interest stemming from their brokers and investment advisers recommending their own asset-management business' financial products [according to one observer]'); see also 'Merrill Lynch: BlackRock and a hard place', *The Economist,* February 18, 2006, 69.

60 Jenny Anderson, 'A Cold Shoulder in London Makes the Juices Run for Deal Financiers in New York', *New York Times,* March 14, 2006.

61 The recent decision by major investment banks to return to private equity operations, after having previously abandoned them due to concerns about conflicts of interests, illustrates the lure of this lucrative line of business: see 'Banks and buyouts: Follow the money', *The Economist,* October 14, 2006, 82 ('Banks cannot resist the perilous lure of private equity.')

62 ASIC Surveillance Report, above n31, para 1.3.

63 See ASIC Discussion Paper, Managing Conflicts of Interest in the Financial Services Industry, (April 2006), p18 ('Conflicts of interest impact the quality of financial services provided …').

64 For example, ASIC's view on what conflicts of interest must be avoided outright to comply with the statute is less than clear.

65 'Chanticleer: ASIC barking up the wrong tree', *The Weekend Australian Financial Review,* July 1-2, 2006, 64 ('The corporate cop seems to have lost its way with its claims against Citigroup by assuming investment banks take the moral high ground, when the reverse is obviously the case… ASIC deputy Jeremy Cooper's concerns about investment bank conflicts are well based but he has the wrong target and his assumption that the banks are not designed to maximise the fee take rather than provide devote attention to anyone client is naïve').

66 See Andrew Tuch 'Obligations of financial advisers in change-of-control transactions: Fiduciary and other questions', above n5.

67 The Parliament of the Commonwealth of Australia, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 Explanatory Memorandum, para. [5.597] (the memorandum explains that complying with the obligation will encompass 'ensuring that there is adequate disclosure of conflicts … [and requiring] internal policies and procedures for *preventing* and addressing potential conflicts of interest…' [emphasis added]).

68 The Securities & Exchange Commission has taken the position that so-called 'Chinese walls' are, by themselves, ineffective to control some conflict situations. Rather, it may be necessary for a firm to 'reinforce' Chinese walls by using measures such as a 'restricted list' that would be triggered at the outset of a firm's relationship with a client. These measures are suggested to represent 'best practice' in the UK. See Chizu Nakajima and Elizabeth Sheffield, *Conflicts of Interest and Chinese Walls* (2002), 132-135. So, for example, at the time an investment bank is engaged to advise a bidder in a proposed takeover, the bidder and (presumably also) the target company would be added to the firm's 'restricted list', with the consequence that the firm could not then trade on its own account in the shares of either company. This measure does more than reinforce the existing information barrier; it ensures that a firm avoids certain conflicts of interest.

69 See Andrew Tuch, 'Investment Banks as Fiduciaries: Implications for Conflicts of Interest', above n6.

70 For a discussion of this issue in an analogous context, see RP Austin and IM Ramsay, *Ford's Principles of Corporations Law* (2005), 410.

71 See Corporations Act 2001 (Cth), ss761A, 766A, 912A(1)(ss).

72 See Andrew Tuch, 'Investment Banks as Fiduciaries: Implications for Conflicts of Interest', above n6.

73 See Corporations Act 2001 (Cth) s912A(1)(aa); and The Parliament of the Commonwealth of Australia, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 Explanatory Memorandum ('CLERP 9 Explanatory Memorandum'), at [5.597].

74 As to whether corporate (or financial) advisory services constitutes providing 'financial services' under the Corporations Act 2001 (Cth), see Andrew Tuch, 'Investment Banks as Fiduciaries: Implications for Conflicts of Interest', above n6, 514 and Andrew Tuch 'Obligations of financial advisers in change-of-control transactions: Fiduciary and other questions', above n5.

75 'Chanticleer: ASIC barking up the wrong tree', above n65. ('Investment banks are inherently walking conflicts of interests and how they handle the conflicts determines how long they will keep clients').