# *ASIC v Citigroup*: Investment banks, conflicts of interest, and Chinese walls

**Pamela F Hanrahan**[1]

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In his Foreword to the 30th edition of *Snell's Equity*, Lord Millet wrote of equity that:

> It has broken through the traditional barriers which would confine its operation to the home and family and entered the business world. It brings with it obligations of loyalty, confidence and good faith, obligations higher than those imposed by the common law, which is satisfied with honesty, careful conduct and keeping one's promises. The exposure of the commercial world to equitable concepts is bringing a host of problems with which we are only now beginning to grapple.[2]

The recent decision of Jacobson J in the Federal Court of Australia in *ASIC v Citigroup Global Markets Australia Pty Ltd* [2007] FCA 963, handed down in July 2007, embodies Lord Millet's concern. In this case, the relationship between an investment bank and a client (to whom it was providing advisory services in relation to a proposed takeover bid) came under the equitable microscope. The case attracted considerable attention both in Australia and overseas. At its heart was the proposition, advanced by Australia's financial services regulator, that proprietary trading in the target company's shares in the lead-up to the takeover (by a division of the bank separate from the advisory team) placed the bank in a situation where its personal interests conflicted with its duty to the bidder client, in breach of a fiduciary duty owed by the bank to that client.

In the event, Jacobson J found that the relationship between the bank and its client was not fiduciary in character. Accordingly, the bank was not subject to a fiduciary duty requiring it to avoid conflicts of interest and duty. His Honour went on to find that, even if the relationship had been fiduciary, the bank's proprietary trading (which

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[1] BA(Hons), LLB(Hons) (*Melb*), LLM(Hons) (*CWRU*), SJD (*Melb*). Barrister and Solicitor, Supreme Court of Victoria and High Court of Australia. Associate Professor of Law, Melbourne Law School and Deputy Director of the Centre for Corporate Law and Securities Regulation, The University of Melbourne.

[2] J McGhee *Snell's Equity,* Sweet & Maxwell, London, 2000 (30th ed).

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took place behind a Chinese wall separating the 'public side' proprietary traders from the 'private side' advisory team) did not, on the facts, give rise to any conflict of interest and duty that would have offended the fiduciary proscription. His Honour went on to find that, even if the trading had given rise to a conflict, the client's fully informed consent to the existence of that conflict could have been implied from the all the circumstances of the dealing between the bank and the client.

Had the decision been otherwise, the concerns of the international investment banking community that the Australian regulator had upset a widespread (but not inevitable) practice in financial conglomerates of combining advisory businesses with equities trading businesses would have been realised. Instead the decision of Jacobson J has confirmed that this practice is not prohibited by equity, provided the relationship between the bank and the client, and the organisation of the conglomerate's business, conforms to certain conventions.

The purpose of this paper is to unpack the conflicts element of the decision, to see what its ramifications might be for investment banks whose operations encompass both advisory and trading arms. It begins with a brief outline of the case, including a discussion of how it was that the financial services regulator came to bring an action based on (private law) fiduciary principles, and of the relationship between the conflicts elements and allegations of insider trading (which the regulator also failed to establish) that were tied up with them. It goes on to look in some more detail at Jacobson J's specific findings in relation to: firstly, the allegation that the relationship between the bank and its client was fiduciary; secondly, the allegation that the bank's proprietary trading gave rise to a conflict of interest and duty; and thirdly, the allegation that the client's informed consent had not been obtained. It then discusses briefly the role of Chinese walls in the management of conflicts. It concludes with some observations about the broader implications of the decision for the application of fiduciary principles to advisory firms and for the (specifically Australian) regulatory landscape. In so doing it draws attention to the complex interplay in commercial relationships between the common law duties and equitable principles, and between the equitable principles *inter se*, to which Lord Millet refers. As the discussion shows, that complexity is increased by the introduction of a third element,



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not mentioned by Lord Millet, which is the co-opting of equitable principles into the (public) regulation of financial services firms.

## The case against Citigroup

The defendant in the Federal Court proceedings was a company called Citigroup Global Markets Australia Pty Ltd (***Citigroup***). Citigroup is the main operating subsidiary in Australia of Citigroup Inc, the global banking and financial services company. Citigroup carries on various businesses in Australia, including a business known internally as the Corporate and Investment Bank (***CIB***). The CIB in turn includes a number of operating divisions, one of which is the Investment Banking Division (***IBD***) which provides advisory services and investment banking services (including in connection with mergers and acquisitions), and another of which (known as Equities) engages in proprietary trading in securities.

### *The Patrick takeover*

On 8 August 2005, Citigroup's IBD was retained by a subsidiary of an Australian listed company called Toll Holdings Limited (***Toll***) to provide financial advisory and investment banking services to it in relation to a proposed takeover by Toll of another listed company, Patrick Corporation Limited (***Patrick***). Toll had been considering a takeover of Patrick for some months, as a means of entering the Australian ports logistics market. The transaction was a sizable one (valued at over AUD 4.5 billion on completion) and the parties were highly sophisticated. Toll appointed two investment banks to advise it in relation to the bid, of which Citigroup was one and the boutique Carnegie Wylie & Co Pty Limited (***Carnegie Wylie***) was the other. Under the terms of the retainer executed on 8 August, Citigroup's IBD fees for successful completion of the takeover were likely to be in the range of AUD 10 to 18 million.

Citigroup's IBD and Equities divisions were separated by formal information and other barriers known in the financial services sector as 'Chinese walls'. Employees working in the IBD division were on the private side of the wall, because they were routinely in possession of non-public price sensitive information about securities (including, in this instance, information about Toll's intentions in relation to Patrick).



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Employees in the Equities division were on the public side of the wall. An important purpose of the Chinese wall was to ensure that Citigroup did not contravene Australia's insider trading laws by trading (through the Equities division) in Patrick shares while in possession (through the IBD division) of non-public price sensitive information about Patrick.

On Friday 19 August 2005, one of the traders in Citigroup's Equities division acquired a substantial number of Patrick shares. There is no suggestion that, at the time he acquired the shares, the trader was in possession of inside information about Toll's proposed bid for Patrick. Rather the trader appears to have been responding to movements in the Patrick price which in turn reflected broader market speculation about the likelihood of Patrick being the subject of a takeover bid (probably by Toll). By mid-afternoon on that Friday the trader had a substantial long position in Patrick, and the Patrick price had risen appreciably. At 3.30pm, the trader's boss took him outside the office for a brief discussion in which he told the trader to stop buying Patrick shares. This is the famous 'cigarette on the pavement' discussion referred to in media reports of the case. The trader came back upstairs to the dealing room and sold down some of his position. As events unfolded, Toll's bid for Patrick was subsequently announced the following business day, on Monday 22 August 2005.

In accordance with normal practice, trading in Patrick shares in the lead-up to the bid was examined by the surveillance division of Australian Securities Exchange Limited (***ASX***), the exchange on which both Toll and Patrick were listed. ASX identified the possibility of insider trading in Patrick by Citigroup and referred the matter to the Australian Securities and Investments Commission (***ASIC***) for investigation. ASIC is the financial markets and financial services regulator in Australia. Following an investigation during late 2005 and early 2006, ASIC commenced proceedings against Citigroup in March 2006.

*The allegations*

ASIC's case against Citigroup evolved between March 2006 and the beginning of the trial in April 2007; there were three substantially different iterations of ASIC's statement of claim, and a number of minor refinements to its pleadings made over that time. But in essence ASIC's allegations were two-fold.

The first was an allegation that, by reason of the proprietary trading, Citigroup had breached certain statutory provisions regulating financial services providers[3] in that it had breached a fiduciary duty owed by it to Toll to avoid conflicts of interest and duty. These allegations are referred to by Jacobson J as the conflicts claims.

The second was an allegation that Citigroup itself (rather than the individual Equities division trader) had engaged in insider trading[4] in Patrick shares. There were two allegations of insider trading; his Honour refers to them as the first and second insider trading claims. The first related to the sale of Patrick shares by the trader after the 'cigarette on the pavement' conversation. The second related to all of the trading that took place on the Friday and was based on ASIC's view that Citigroup was not entitled (for the reasons pleaded) to rely on the Chinese wall defence to insider trading by corporations.[5] In the absence of the Chinese wall defence, the knowledge of

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[3] Those sections are s 912A(1)(aa) and s 1041H of the *Corporations Act 2001* (Cth) (the ***Corporations Act***) and s 12CA and s 12DA of the *Australian Securities and Investments Commission Act 2001* (Cth) (the ***ASIC Act***). The relationship between these sections and the allegation of breach of fiduciary duty made by ASIC is explained below.

[4] Insider trading is prohibited by s 1043A of the Corporations Act. In essence, the section provides that a person who possesses inside information about securities, and who knows or ought to know those things that give the information the character of inside information, may not trade in those securities or procure another person to trade in those securities. Information is inside information if the information is not generally available, and, if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of securities: see s 1042A – 1042D of the Corporations Act.

[5] The Chinese wall defence is contained in s 1043F of the Corporations Act. It is to the effect that a body corporate does not contravene the insider trading prohibition by entering into a transaction at any time merely because of information in the possession of an officer or employee if three conditions are met. The first is that the decision to enter into the transaction was made by a person other than the person in possession of the information. The second is that the body corporate 'had in operation at that time arrangements that could reasonably be expected to ensure that the information was not communicated to the person or persons who made the decision and that no advice with respect to the transaction or agreement was given to that person or any of those persons by a person in possession of the information' (this is the so-called Chinese wall requirement). The third is that the information was not so communicated and no such advice was so given.

Citigroup's IBD team would, of course, have been knowledge of Citigroup that it possessed while the Equities division was trading in Patrick shares.

This paper confines itself to a discussion of the conflicts claims; suffice to say in relation to the insider trading claims that ASIC was unsuccessful in both: see [2007] FCA 963 at [466] to [598]. In relation to the first claim, Jacobson J decided that the trader was not an 'officer' of Citigroup and accordingly that any information he might or might not have possessed following the 'cigarette on the pavement' conversation could not be attributed to Citigroup.[6] In relation to the second insider trading claim, his Honour concluded that the requirements of the insider trading defence were met, including the requirement that Citigroup have in place 'arrangements that could reasonably be expected to ensure that' information or advice did not cross from the private side to the public side. In other words, his Honour found that Citigroup's Chinese wall was adequate to repel an allegation of insider trading at the company level.

## The conflicts claims

We now turn to look in some more detail at the nature of the conflicts claims made by ASIC against Citigroup.

As noted above, the essence of the conflicts claims was that Citigroup had breached certain parts of the Australian financial services laws *in that* it had breached a fiduciary duty owed by it to Toll to avoid conflicts of interest and duty.

ASIC said that this alleged breach of fiduciary duty by Citigroup:

- meant that Citigroup did not 'have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by [Citigroup] or its representatives in the provision of financial services as part of [its] financial services business'.

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[6] The effect of s 1042G(1)(a) of the Corporations Act is inside information is only taken to be possessed by a body corporate if it is possessed by an 'officer' as defined in s 9. The trader was not an officer, only an employee: see [479] to [501]. But it is clear from his Honour's findings in relation to a range of other issues raised by the first insider trading claim (at [502] to [571]) that ASIC would have failed in this claim even if the trader had been an officer of Citigroup.

Citigroup was required to have in place such arrangements because it holds an Australian financial services (***AFS***) licence issued under Pt 7.6 of the *Corporations Act 2001* (Cth) (the ***Corporations Act***);[7]

- amounted to misleading or deceptive conduct in relation to financial services, in contravention of the Corporations Act and the *Australian Securities and Investments Commission Act 2001* (Cth) (the ***ASIC Act***);[8]
- amounted to unconscionable conduct in contravention of the ASIC Act.[9]

The relevant provisions of the financial services laws are provisions in relation to which ASIC has standing to bring civil proceedings in the Federal Court for non-compliance. ASIC sought various orders from the Court in relation to the alleged contraventions, including declarations that Citigroup's actions were in breach of the law, and injunctions requiring Citigroup to take certain steps to correct those breaches.[10]

It is important to note that, in formulating and pleading its case against Citigroup, ASIC chose to argue only that Citigroup had contravened these statutory provisions by being in breach of a fiduciary duty owed to by Citigroup to Toll. ASIC did not argue that Citigroup contravened the statutory provisions in any other way. Accordingly, as Jacobson J points out, the gravamen of ASIC's case becomes whether Citigroup owed fiduciary duties to Toll. Perhaps there is an open question about whether Citigroup's conduct might have contravened these provisions in some other way, other than by being a breach of fiduciary duty (although there is nothing in Jacobson J's findings to suggest that it would). However because of the way ASIC's case was structured, if it failed to establish breach of fiduciary duty on the part of

[7] The requirement on AFS licensees to have adequate arrangements for the management of conflicts of interest is contained in s 912A(1)(aa) of the Corporations Act.

[8] Misleading or deceptive conduct in relation to financial services is prohibited under s 1041H of the Corporations Act and s 12DA of the ASIC Act.

[9] Unconscionable conduct is prohibited by s 12CA of the ASIC Act.

[10] See ASIC's Further Amended Statement of Claim dated 26 March 2007, available at http://www.asic.gov.au/asic/asic.nsf/byheadline/ASIC+v+Citigroup?openDocument.

Citigroup then it also (necessarily) failed to establish the statutory contraventions that it alleged.

In order to establish that Citigroup's proprietary trading in Patrick shares amounted to a breach of a fiduciary duty owed by Citigroup to Toll, ASIC would have had to establish three things. They were: first, that the relationship between Citigroup and Toll was fiduciary in character and that accordingly Citigroup was required to avoid conflicts between its personal interests and its duties to Toll; secondly, that the proprietary trading undertaken by Citigroup on the Friday created a conflict of interest and duty; and thirdly, that Citigroup did not have Toll's informed consent to the existence of the conflict.

In order to establish the second of these things, ASIC had (at least in respect of one part of its case) to go one step further and establish that, because it was in a fiduciary relationship with Toll, Citigroup owed Toll a positive duty to disclose all matters relevant to its mandate of which it was aware. Such a duty was said by ASIC to be derived from the observations of Brennan J in the High Court of Australia in *Daly v The Sydney Stock Exchange Limited* (1986) 160 CLR 371 at 385.

Jacobson J decided against ASIC on all of these issues. The reasons why, and the wider implications of his Honour's findings, are explored below.

**Issue 1 – the fiduciary point**

In order to succeed in the conflicts claims, ASIC had to establish first that the relationship between Citigroup and Toll was fiduciary in character. In this regard his Honour was referred to an article by Dr Andrew Tuch, published in 2005 in the *Melbourne University Law Review*, which argued that investment banks would most likely owe fiduciary duties to their clients in the discharge of the advisory functions.[11]

The problem for ASIC was that the mandate letter, executed by Citigroup and Toll on 8 August, expressly provided that the relationship was not fiduciary. Specifically, the mandate letter included the following sentence:

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[11] A Tuch 'Investment Banks as Fiduciaries: Implications for Conflicts of Interest' (2005) 29 *Melbourne University Law Review* 478.

> The Company acknowledges that Citigroup has been retained hereunder solely as an adviser to the Company, and not as an adviser to or agent of any other person, and that the Company's engagement of Citigroup is as an independent contractor and not in any other capacity including as a fiduciary.[12]

Citigroup argued that, in the face of this express contractual stipulation that its relationship with Toll was not fiduciary, it was not open to Jacobson J to find that it was. In reply, ASIC contended that the contractual stipulation would be effective to exclude the fiduciary relationship only if Citigroup had obtained Toll's informed consent to the inclusion of the provision.

As Jacobson J notes at [20] and [22]:

> The gravamen of ASIC's case is that for the exclusion of the fiduciary relationship in the mandate letter to be effective, it was incumbent upon Citigroup to draw Toll's attention expressly to the effect of the exclusion, that is, that it permitted Citigroup to trade in Patrick shares on its own account, in potential conflict with the interests of Toll…
>
> The substance of Citigroup's answer to the claim is that the duty of a fiduciary to obtain the informed consent of a client has no application here because it presupposes the existence of an antecedent fiduciary relationship. No such pre-existing relation is claimed to have been created.

By framing its case in this way, ASIC created (essentially) two sub-issues. The first is whether, but for the contractual stipulation to the contrary, the relationship would have been fiduciary. The second is whether, and if so on what basis, the contractual stipulation is effective to prevent a fiduciary relationship arising between the parties.

*The fiduciary character of advisory relationships*

Interestingly, Jacobson J concludes at [325] that 'but for the express terms of the mandate letter, the pre-contract dealings between Citigroup and Toll would have pointed strongly towards the existence of a fiduciary relationship in Citigroup's role as an adviser'.

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[12] [2007] FCA 963 at [145].

In that respect his Honour comes to a similar conclusion as Dr Tuch.[13] He notes, also at [325], that as is shown by the decisions in *Daly v The Sydney Stock Exchange Limited*, above, *Hadid v Lengest Communications Inc* [1999] FCA 1798 and *Aequitas v AEFC* (2001) 19 ACLC 1006, an adviser 'may have fiduciary obligations to the client'. The basis upon which Jacobson J comes to this conclusion is explained at [282] to [286], which set out the orthodox bases upon which a relationship that falls outside one of the established categories may be treated by equity as fiduciary. At [286], his Honour notes that 'vulnerability of the client is one of the indicia of the fiduciary relationship'. However that vulnerability is judged not by reference to the sophistication (or otherwise) of the client, but rather by having regard to 'the special opportunity of the adviser to abuse the expectation of loyalty'.

In Aequitas, above, at [307], Austin J said that:

> The fiduciary relationship between financial adviser and client arises because the financial adviser, having held itself out as an adviser on matters of investment, undertakes a particular financial advisory role for the client: *Daly v Sydney Stock Exchange Ltd*, 160 CLR at 377 per Gibbs CJ; 384-385 per Brennan J. The advisory fiduciary relationship may arise whether or not there is an anterior fiduciary relationship between the parties, such as the relationship of broker and client. The relationship can arise even where parties are dealing with one another in a transaction in which the adviser has an obvious commercial self-interest. Thus, 'a bank may be expected to act in its own interests in ensuring the security of its position as lender to its customer, but it may have created in the customer the expectation that it will nevertheless advise in the customer's interests as to the wisdom of a proposed investment': *Commonwealth Bank of Australia v Smith* (1991) 42 FCR 390, 391. But unless there is, in all the circumstances, the requisite undertaking, the adviser is under no fiduciary duty and is free to pursue its own interests: *Noranda Australia Ltd v Lachlan Resources NL* (1988) 14 NSWLR 1, 15-17.

It is true that the cases to which Jacobson J refers establish a fiduciary relationship between an adviser and a client, in circumstances where 'the adviser holds itself out as an expert on financial matters and undertakes to perform a financial advisory role for the client' (at [283]). However the test, expressed in those terms, is potentially very broad. The established categories of fiduciary relationship (with the possible exception of the advisory aspects of the relationship between solicitor and client, which is arguably a special case for reasons alluded to at [303] of the judgment) all

[13] See n 11 above.

exhibit what Mason J described in *Hospital Products,* above, as the 'critical feature'; that the fiduciary 'undertakes or agrees to act for or on behalf of or in the interests of another person *in the exercise of a power or discretion which will affect the interests of that other person* in a legal or practical sense' (emphasis added).[14] Unlike a trustee, director, agent, employee or partner, an adviser does not exercise any power or discretion as part of its function. It simply advises, and the client is free to act upon or reject that advice. In the Citigroup case, Toll had retained two advisers – Citigroup and Carnegie Wylie. Presumably it did so on the basis that its own experienced mergers and acquisitions team would take into account the (perhaps differing) advice given by these advisers, and exercise its own judgment in making the final decisions relating to the Patrick bid. The case for finding that the relationship was fiduciary might be thought of as weaker in this circumstance, than in the particular circumstances in *Daly, Hadid* and *Aequitas,* to which his Honour referred.

Ultimately, though, as Jacobson J points out at [266], 'the question of whether a fiduciary relationship exists, and the scope of any duty, will depend upon the factual circumstances and an examination of the contractual terms between the parties'. His Honour goes on to point out, at [281], that where (as here):

> … a fiduciary relationship is said to be founded upon a contract, the ordinary rules of construction of contracts apply. Thus, whether a part is subject to fiduciary obligations, and the scope of any fiduciary duties, is to be determined by construing the contract as a whole in light of the surrounding circumstances known to the parties and the purpose and object of the transaction: see *Pacific Carriers Limited v BNP Paribas* (2004) 218 CLR 451 at [22] per Gleeson CJ, Gummow, Hayne, Callinan and Heydon JJ; *Toll (FGCT) Pty Limited v Alphapharm Pty Limited* (2004) 219 CLR 165 at [40] per Gleeson CJ, Gummow, Hayne, Callinan and Heydon JJ; *Lion Nathan Australia Pty Limited v Coopers Brewery Limited* (2006) 156 FCR 1 at [46] per Weinberg J.

In light of that conclusion, the key consideration for Jacobson J was how the contractual stipulation in the mandate letter (to the effect that the relationship was not fiduciary) should be treated in construing the contract between Citigroup and Toll.

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[14] *Hospital Products Limited v United States Surgical Corporation* (1984) 156 CLR 41 at 96-7.

*The effect of the contractual stipulation*

It is settled law that, where a person is already subject to fiduciary obligations, they must obtain the fully informed consent of the other person to the exclusion or modification of those obligations. Jacobson J confirms this general principle at [307]. Importantly, though, his Honour concludes that this principle (that fully informed consent is required to exclude the fiduciary obligations) can have no application except where the parties are in an established category of fiduciary relationship (such as trustee and beneficiary, solicitor and client, or agent and principal) or 'at very least, to those who carry fiduciary obligations before the execution of the contract' (at [305]). To hold otherwise, his Honour says at [346], 'would be to say that a person who is not a fiduciary may nevertheless owe an obligation which flows from a fiduciary relationship. That could hardly be correct'.

It is of the utmost significant in the context of this part of the decision that ASIC alleged that the fiduciary relationship arose out of the mandate letter,[15] and did not pre-date it.

The relationship between a financial adviser and its client, if it is fiduciary at all (see above), is not one of the established categories of fiduciary relationship.[16] Accordingly, his Honour found that the principle that the client's fully informed consent to the exclusion or modification of the fiduciary duties was required had no application. Instead, as the mandate letter was to be interpreted in accordance with ordinary principles of contract, the contractual stipulation should be given its full effect in the absence of some contractual flaw like mistake or misrepresentation.

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[15] ASIC disavowed the existence of a fiduciary relationship pre-dating the actual execution of the mandate letter: see [24] and [306]. As his Honour points out, this distinguishes the situation from that which arose in *United Dominions Corporation Limited v Brian Pty Limited* (1985) 157 CLR 1 at 11-12 per Mason, Brennan and Deane JJ.

[16] The established categories include trustee and beneficiary, agent and principal, solicitor and client, director and company, employee and employer, and partners: see *Hospital Products Limited v United States Surgical Corporation* (1984) 156 CLR 41 at 68 per Gibbs CJ, at 96 per Mason J.

On this basis, his Honour decided that the relationship between Citigroup and Toll was not fiduciary. He concluded (at [337]) that 'the exclusion of the fiduciary relationship was effective, notwithstanding the fact that Citigroup undertook to provide financial advisory services to Toll and that both parties' interests were "well aligned" in the fee structure set out in the mandate letter'.

That said, it is perhaps telling that Jacobson J makes two further observations about what ASIC *did not* argue in relation to the effect of the contractual stipulation. He notes (at [333]) that 'ASIC did not suggest that the factual matrix, or the object or purpose of the mandate letter, could bear upon the proper construction of the acknowledgement that the relationship between the parties was not fiduciary'. Nor, he notes (at [334]), did ASIC argue 'that the words "including as a fiduciary" should be limited or read down by anything else in the terms of the lengthy acknowledgement'. In so doing his Honour is at least inviting speculation about whether the result might have been different had ASIC done so.

### Issue 2 - the conflicts point

Having concluded that the relationship between Citigroup and Toll was not fiduciary, Jacobson J was not required to go further and decide whether Citigroup's proprietary trading in Patrick shares on the Friday before the bid was announced created for it a conflict of interest and duty that would be prohibited by equity. Nevertheless his Honour goes on, at [369] to [420], to address the allegations of conflict made by ASIC in its Further Amended Statement of Claim.[17] ASIC alleged that Citigroup's proprietary trading gave rise to five separate conflicts of interest and duty. Significantly, his Honour found against ASIC on all five allegations.

This bears repeating. Jacobson J found at [369] that, even if a fiduciary relationship had existed between Citigroup and Toll, Citigroup's proprietary trading would not, in the circumstances, have given rise to a proscribed conflict of interest and duty.

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[17] See n 11 above.

*The Daly positive duty of disclosure*

The first three of ASIC's allegations of conflict rested upon its argument that, as a fiduciary, Citigroup had a positive duty to disclose to Toll all information in its possession that might be relevant to the relationship and the advice provided under it. ASIC alleged that Citigroup had a personal interest that conflicted with the performance of this duty. ASIC said that Citigroup owed a positive duty of disclosure to Toll on the basis of the observations of Brennan J in *Daly v The Sydney Stock Exchange Limited*, above.

In this regard Jacobson J said at [375] that:

> There is force in Citigroup's submission that Australian law does not recognise a fiduciary duty to make full disclosure. The strong weight of judicial authority is that fiduciary duties are proscriptive rather than prescriptive; accordingly, a fiduciary does not have a positive duty to disclose information… It may follow that Brennan J's observations in *Daly* are to be confined in the manner discussed by Austin J in *Aequitas* at [287].... However I do not need to consider this question because in my view the claim [relating to the first alleged conflict] fails at a factual level.

In *Aequitas v AEFC*, above, Austin J said (at [287]) that:

> In my opinion, in light of the reasoning in *Breen v Williams* [(1996) 186 CLR 71], Brennan J's dictum [in *Daly*] should be taken to refer, for the most part, to the contractual aspects of the adviser-client relationship. The duty to provide 'best advice' and to disclose knowledge and information arise out of the adviser's 'undertaking' … are therefore implied terms of the contractual retainer. And disclosure may also relieve the adviser from the fundamental fiduciary duty not to 'assume a position where his self-interest might conflict with the honest and impartial giving of advice'.

ASIC's first three allegations of conflict relied upon it establishing that Citigroup had a positive duty, under *Daly*, to disclose certain information known to particular employees of Citigroup to Toll about its position in Patrick shares, and the impact of its proprietary trading on the market for Patrick in the lead-up to the bid. Jacobson J rejected (impliedly if not expressly) the existence of such a duty. ASIC said that the interest that Citigroup had that conflicted with this duty was its interest 'in maintaining its relationship with Toll, free from a perception by Toll that Citigroup's Chinese walls had failed': see [374] and also [380] and [388]. On the facts, his Honour rejected each of those claims.

*The fourth and fifth allegations*

The fourth allegation of conflict related to what was essentially a conflict of interests, rather than a conflict of interest and duty. ASIC alleged that it was in the interests of Toll that the price of Patrick shares not increase, because if it did it would affect the credibility of the bid (see [395]). This is because an increase in the price of Patrick shares would lead to an erosion of the apparent premium being offered by Toll over the pre-bid market price of Patrick shares. Citigroup's proprietary trading in Patrick shares gave it a contrary interest in the price of Patrick, that it should go up so as to produce a profit in the proprietary trader's long position (at [396]).

Jacobson J does not address the apparent inconsistency between his characterising all five of ASIC's claims as being based on conflict of interest and duty (see [369]) and his treatment of the fourth claim (correctly, it is submitted) as being based on a conflict of interest and interest. In other words, the fourth claim can properly be characterised as one involving, not a conflict of interest and duty, but a situation in which one party to the arrangement has a commercial interest which diverges from that of the other. Unlike the first to third claims, and the fifth, ASIC has not here alleged any duty on the part of Citigroup with which its interest in the price of Patrick shares might conflict.

Jacobson J decided against ASIC on the fourth conflict claim, on the basis (at [403]) that it failed to establish the Toll had the interest alleged (that is, an interest that the price of Patrick shares should not rise during trading on 19 August). In essence, this was because an earlier date (26 July) had already been selected as the reference date for the bid – that is, as the appropriate date from which to measure the premium (see [399]). Accordingly ASIC failed to establish that 'noise' in the Patrick price on the last business day before the bid was material to Toll in relation to the calculation of the bid premium.

The fifth allegation of conflict seems, on the basis of his Honour's observation at [413], to be the strongest, although it ultimately failed at a factual level (at [416]). The allegation relates to the position in which Citigroup found itself in the afternoon and evening of 19 August, when members of its senior management and compliance teams became aware of Citigroup's substantial proprietary shareholding in Toll.

The allegation made by ASIC is that Citigroup's interest in the price of Patrick shares conflicted at this point with its duty to provide disinterested and loyal advice to Toll. As his Honour goes on to note at [412]:

> The pleaded case is confined by the particulars. Two risks are asserted. The first is that Citigroup had an interest in preserving its reputation free from a perception that its Chinese walls had failed. The second is that the senior management might be required to make a decision as to whether the bid price should be increased. It is said that this could occur if [the IBD team leader] or Toll sought senior management's view as to the issue of the bid price.

The reason the claim failed was because his Honour found that there was 'no evidence to support that allegation that there was a risk that' the views of senior management on the bid price would be sought.

### Issue 3 – informed consent

Having concluded that the relationship between Citigroup and Toll was not fiduciary, and that even if it was there was no conflict of interest and duty, Jacobson J was not required to decide whether Toll had given informed consent to Citigroup's proprietary trading activities. Nevertheless his Honour does go on to conclude that Toll's informed consent to Citigroup's proprietary trading could be implied from the circumstances.

As noted (in relation to issue 1) above, the question of informed consent arises in relation to two separate aspects of the judgment. The first relates to whether informed consent was required and obtained to the inclusion of the contractual stipulation in the mandate letter that excluded a fiduciary relationship between the parties. His Honour held on this point that informed consent was not required because the relationship was not fiduciary at the time the mandate letter was signed (noting that ASIC pleaded that the fiduciary relationship arose out of the mandate letter and did not pre-date it). This is discussed above.

The second relates to (the obiter question of) whether informed consent was obtained to Citigroup being in a position of conflict as a result of its proprietary trading in Patrick shares.

The broader context for this second consideration of the nature of informed consent is that a fiduciary is not prohibited from being in a position of conflict, or from profiting

from its office, if it has the fully informed consent of the person to whom its duty is owed.[18] So in other words, even if Citigroup were in a fiduciary relationship with Toll, it would be able to overcome any potential conflict of interest and duty raised by its proprietary trading through obtaining Toll's fully informed consent.

His Honour found (at [355]) that:

> Citigroup did not obtain Toll's express consent to trade on its own account in the context of its advisory role in the Patrick takeover, but in my view informed consent is to be implied from Toll's knowledge of Citigroup's structure and method of operations. Toll's experience and "core competency" in mergers and acquisitions must also be taken into account in determining this question: See *Farah Constructions Pty Limited v Say-Dee Pty Limited* [2007] HCA 22 at [107] per Gleeson CJ, Gummow, Callinan, Heydon and Crennan JJ.

The point Jacobson J makes in relation to the consent is that there must be actual consent. That consent may be express or implied – here it was implied from the dealings between the parties. His Honour expressly (and rightly, it is submitted) distinguishes this from the situation in *Kelly v Cooper* [1993] AC 205, where the contract between a real estate agent and its client was held to include an implied term allowing the agent to act for other principals selling similar properties. That term was implied by Lord Browne-Wilkinson (at 214) because the practice is notorious and it would otherwise be impossible for real estate agents to perform their ordinary business functions. Jacobson J is at pains to point out that this is not the case here: he says (at [360]) that 'there is nothing in the relationship of investment banker/financial adviser 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'. Accordingly the client's actual (albeit implied) consent is required.

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[18] For example, in *Consul Developments Pty Ltd v DPC Estates Ltd* (1975) 132 CLR 373 at 377, McTiernan J notes that 'if after full and frank disclosure of all material facts to the person to whom such a duty … is owed and permission has been given to make a profit for himself out of transactions which would otherwise be in breach of duty he is, of course, absolved from any obligation to account'.

**Issue 4 – conflicts management and Chinese walls**

The discussion of issues 1, 2 and 3, above, deals with the core fiduciary arguments on which ASIC's case was based. We now move to consider a related issue, which arises out of the statutory obligation on financial services firms to manage conflicts of interest. In essence, that issue is: do Chinese walls work as a means of managing conflicts of interest?

The answer to that broader question, at least in the context of the *Citigroup* case, is complicated by the particular statutory context in which it arises. Under Australian law, people who carry on a business of providing financial services are required to hold an AFS licence; Citigroup held such a licence. Among other things, the Corporations Act provides (at s 912A(1)(aa)) that an AFS licensee must '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 or a representative of the licensee in the provision of financial services as part of the financial services business'. This is one of the statutory provisions on which ASIC's civil proceedings against Citigroup were based.

ASIC's case against Citigroup was that Citigroup had breached this duty by having breached a fiduciary duty owed by it to Toll. Having failed to establish that the relationship was fiduciary, ASIC necessarily failed to establish a breach of s 912A(1)(aa). Jacobson J notes at [422] that

> ASIC did not concede that as a matter of construction the obligation in s 912A(1)(aa) only applies to a licensee who occupies a fiduciary position. However, ASIC did concede that in the present case that is how the conflict is said to arise. That is, the subsection is not engaged unless Citigroup and Toll were in a fiduciary relationship.

In fact, s 912A(1)(aa) did not apply to Citigroup in this context: see [440]. The reason for this is that investment banking is expressly excluded from being treated as the provision of a financial service for the purposes of the Corporations Act, by reg 7.1.29(3)(c) of the Corporations Regulations 2001. The conflicts management obligation in s 912A(1)(aa) only applies to conflicts that arise in relation to activities undertaken by a licensee in 'the provision of financial services'. Because Citigroup

was not providing a financial service, the conflicts management obligation did not apply.

Nevertheless, Jacobson J makes some useful (although necessarily limited) comments about what might amount to the adequate management of conflicts in the contemplation of a provision like s 912A(1)(aa). First, his Honour confirmed that, on the words of the statute, the 'management' of conflicts did not require their elimination (for example, by obtaining the client's express consent): [443] to [445]. Secondly, his Honour confirmed that Chinese walls can be an effective means of managing conflicts that might arise in this context: [448] to [452]. Thirdly, his Honour re-confirmed that more than formal policies are required; there must be real engagement with the business for the wall to be effective: [453] to [454].

*Chinese walls*

At [310], [318] to [319] and [448] to [452], Jacobson J adopts with approval the approach to Chinese walls taken by the UK Law Commission in its *Consultation Paper No 124* (1992)[19] and by Lord Millet in *Prince Jefri Bolkiah v KPMG* [1999] 2 AC 222.[20]

His Honour begins by pointing out that Chinese walls do not, of themselves, eliminate conflicts of interest and duty. He then goes on (at [315]), to make this important observation:

> However, as the UK Law Commission observed, a financial conglomerate may obtain protection against any allegation of breach of the duty of loyalty if the client consents to the company carrying on business using Chinese walls as part of its organisational structure. The extent of the duty of loyalty would then be determined according to the contractual arrangements between the parties: see *Law Commission Consultation Paper* at [4.5.1].

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[19] Law Commission, United Kingdom, *Fiduciary Duties and Regulatory Rules*, Consultation Paper No 124 (1992) at [4.5]. The final report is Report No 236 (1995).

[20] See also C Hollander and S Salzedo, *Conflicts of Interest and Chinese Walls*, Sweet & Maxwell, London, 2004 (4th ed).

In other words, the combination of an effective Chinese wall and the client's consent given on the basis that the wall is in place and robust should be sufficient to avoid any allegation of conflict on the part of the conglomerate.

What makes an effective Chinese wall? His Honour expressly adopts (at [319]) the criteria developed by the Law Commission and articulated by Lord Millet in *Bolkiah,* above, that there should be: (i) the physical separation of departments to insulate them from each other; (ii) an educational programme, normally recurring, to emphasise the importance of not improperly or inadvertently divulging confidential information; (iii) strict and carefully defined procedures for dealing with situations where it is thought the wall should be crossed, and the maintaining of proper records where this occurs; (iv) monitoring by compliance officers of the effectiveness of the Chinese wall; and (v) disciplinary sanctions where there has been a breach of the wall.

Jacobson J goes on to refer with approval (at [320]) to the comments of Bryson J in *D&J Constructions Pty Limited v Head and ors trading as Clayton Utz* (1987) 9 NSWLR 118 at 123, that 'it is not realistic to place reliance on such arrangement in relation to people with opportunities for daily contact over long periods'. Jacobson J cautions (at [454]) that:

> Adequate arrangements require more than a raft of written policies and procedures. They require a thorough understanding of the procedures by all employees and a willingness and ability to apply them to a host of possible conflicts.

This is an important caution.

### Implications for advisers

Jacobson J's decision in *ASIC v Citigroup* does not in any way fundamentally change our understanding of the legal position of investment banks providing advisory services to sophisticated clients. Nevertheless his Honour does make a number of findings about the application of fiduciary duties to investment banks that are of significance for them and for other corporate advisers.

The *first* is that, but for the contractual stipulation that it was not, Jacobson J would have been inclined to treat the relationship between Citigroup and Toll as fiduciary.

The *second* is that a provision in a contract to the effect that the relationship created by the contract is not, and is not understood by either party to be, fiduciary should be effective to exclude a fiduciary relationship, so long as there is no mistake or misrepresentation or other contractual flaw. The fully informed (as distinct from ordinary contractual) consent of the affected party to the inclusion of such a provision is not required where the relationship is not one of the established categories of fiduciary relationship (such as agent and principal or trustee and beneficiary) and it cannot be shown (or, as in this case, it is not alleged) that a fiduciary relationship arose from the pre-contractual dealings between the parties.

The *third* is that where the relationship between the parties is one of the accepted fiduciary relationships or their pre-contractual dealings gave rise to fiduciary obligations, the fully informed consent of the affected party to the inclusion of a provision limiting or removing the fiduciary proscriptions would be required.

The *fourth* is that equity will only prohibit a fiduciary from having an interest that conflicts with a duty owed by the fiduciary to the client where the nature of the interest, the extent of the duty, and the impact of the interest on the duty can be clearly demonstrated.

The *fifth* is that, where equity requires a person's informed consent to a relaxation or exclusion of the fiduciary proscriptions, that consent can be express or implied. Actual consent (whether express or implied) is required unless the state of affairs giving rise to the alleged conflict is notorious and is inherent to the fiduciary's ordinary business, in which case courts will imply into the arrangement a term permitting that state of affairs to exist.

The *sixth* is that an effective Chinese wall, combined with the consent of the client to a fiduciary carrying on operations behind that wall that would otherwise have contravened the fiduciary proscriptions, will protect a financial conglomerate from allegations of breach of its duties of loyalty to the client.

### *The nature of fiduciary duties*

More broadly, the decision invites reflection on the nature of fiduciary duties and the relationship between the fiduciary obligations of loyalty and the other equitable and

common law obligations (including obligations of confidence and good faith) that are referred to by Lord Millet in his Foreword to *Snell's Equity*, above.

The question of whether Citigroup was in a fiduciary relationship with Toll was significant not in and of itself, but because a finding that the relationship was fiduciary would have indicated the application of the fiduciary proscriptions – the no conflicts rule and the no profits rule. These are the duties of loyalty to which Lord Millet refers. Finding that Citigroup is not a fiduciary means that the duties of loyalty do not apply, but the other equitable and common law duties still do.

In the execution of the mandate, Citigroup clearly came into possession of confidential information owned by Toll that would be and is protected by equity;[21] this is not in doubt. The restrictions that apply to Citigroup in the use of that information (specifically, preventing it from misusing that information for its own gain) apply regardless of whether the relationship between Citigroup and Toll is fiduciary. In other words is it not necessary to show that a fiduciary relationship exists before the sorts of protections that surround confidential information are triggered.

Similarly a finding that a particular relationship is not fiduciary will not of itself affect the application of a (positive) duty to a person to act in the interests of another person, where such a duty otherwise arises either as a matter of contract or under (other) equitable principles.

The relationship between the positive duty to act in the interests of another person, and the negative duties to avoid unauthorised conflicts and unauthorised profits, is explained by Austin J in *Aequitas v AEFC*, above at [284]. There his Honour concluded that:

> In the High Court's view [in *Breen v Williams* (1986) 186 CLR 71], the essential fiduciary obligations were to avoid conflicts between interest and duty or between duty and duty, and profits arising out of the fiduciary office, in the absence of fully informed consent. Obligations to act in the interests of

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[21] See R Meagher, D Heydon and M Leeming *Meagher, Gummow & Lehane's Equity: Doctrines and Remedies* LexisNexis Butterworths, Sydney, 2002 (4th ed) Ch 41 'Confidential Information', particularly [41-050].

> another, or to act prudently, are not fiduciary obligations. According to Dawson and Toohey JJ (at 93), what the law extracts from a fiduciary relationship is loyalty, often of an uncompromising kind, but no more than that. Gaudron and McHugh JJ (at 113) held that a fiduciary is obliged not to obtain any unauthorised benefit from the relationship and not to be in a position of conflict, but 'the law of this country does not otherwise impose positive legal duties on the fiduciary to act in the interests of the person to whom the duty is owed'. Gummow J (at 137) said that the special position of the trustee does not provide a proper foundation for 'the imposition upon fiduciaries in general of a quasi-tortious duty to act solely in the best interests of their principals'. Fiduciary obligations often arise in cases where one person is under an obligation to act in the interests of another, but that does not mean that the obligation to act in the interests of another is a fiduciary obligation.

While the existence of a duty on one person to act in the interests of another person might be a necessary pre-condition for finding that the relationship between them is fiduciary, it is not a sufficient condition on its own. Nor, as Austin J points out, is the duty itself a fiduciary duty. A person might have undertaken to act in the interests of another person, giving rise to a duty in contract or in equity to do so. However as Jacobson J concludes in *Citigroup* (at [272]), the relationship between them will only be fiduciary if that person 'has undertaken to act in the interests of another *and not in his or her own interests*' (emphasis added). Even then 'all the facts and circumstances must be carefully examined to see whether the relationship is, in substance, fiduciary'. So for a relationship to be fiduciary there needs to be an expectation not only that one person will act in the interests of another, but also that they will subsume or sacrifice their own interests to do so.

### Implications for regulation

In addition to its implications for advisers, the decision in *ASIC v Citigroup* obviously has implications for Australia's financial services regulation.

In commencing proceedings against Citigroup, it seems that ASIC was not primarily concerned with protecting the interests of Toll. Had it wished to complain about Citigroup's proprietary trading in Patrick shares, Toll presumably had sufficient resources of its own to do so. In fact, it appears from Jacobson J's judgment that Toll had no complaint (or at least no complaint that it wished to air in court); the evidence of Toll's Chief Financial Officer indicated that Toll understood that Citigroup would

engage in proprietary trading, and had no objection so long as Citigroup did not misuse Toll's confidential information.[22]

Accordingly ASIC appears to have been acting in pursuit of a broader aim, directed at the integrity of the capital markets and of the actions of those who participate in them. In its press release issued on 31 March 2006 when the proceedings were commenced, ASIC's Deputy Chairman said 'this is a significant case raising two very important issues for the securities industry: having adequate arrangements for managing inside information and dealing with conflicts of interest'. ASIC's intention appears to have been force some change to existing investment banking practice (with which Citigroup was complying) in relation to these areas.

As is clear from Jacobson J's judgment (from which ASIC has since indicated it will not appeal), ASIC's case in these areas was weak. Indeed, in terms of a case to test important principles about conflicts of interest and inside information, it could be characterised as poorly chosen and run. In particular, the case does little to enhance our understanding of the application of s 912A(1)(aa) outside the context of fiduciary relationships, or of the correctness of ASIC's Regulatory Guide 181 *Licensing: Managing conflicts of interest* (30 August 2004). The author's own view is that s 912A(1)(aa) is fundamentally flawed and should be repealed. Instead a licensee's conduct ought to be measured, as it traditionally has been, by reference to what is efficient, honest and fair (see s 912A(1)(a) of the Corporations Act).[23]

Beyond this, the approach taken in the *Citigroup* case makes plain the fundamental difficulty with co-opting fiduciary principles into a regulatory framework. Here ASIC

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[22] At [357] and [358] Jacobson J says: 'It is true that [the Chief Financial Officer of Toll] did not turn his mind to the question of whether Citigroup would suspend its proprietary trading during the period of the mandate, but the effect of his evidence was that he accepted Citigroup could trade for third parties or for itself, so long as it did not use Toll's confidential information…. Moreover, [he] did not believe that Citigroup had an obligation to inform Toll if it engaged in proprietary trading, so long as there was no possibility of Citigroup using Toll's confidential information'.

[23] For a detailed discussion of the relationship between an AFS licensee and its clients, see R Baxt, A Black and P Hanrahan *Securities and Financial Services Law,* LexisNexis Butterworths, 2003, (6th ed) Ch 12 and 13.

has sought to rely on a (private) fiduciary principle to achieve a (public) regulatory aim. The reason why this does not work is that fiduciary principles are applied having regard to the particular understanding and circumstances of the parties to the relationship, not to broader considerations about market integrity. If, as in the *Citigroup* case, the parties agree that the fiduciary proscriptions should not apply, or should apply in a limited way, then a Court will accept this, unless a statute expressly prevents contracting out of or limiting the fiduciary duties.[24] As Professor John Langbein has observed in relation to fiduciary principles in trust law (and this is equally true of fiduciary relationships based on contracts):

> Despite decades of pulpit-thumping rhetoric about the sanctity of fiduciary obligations, fiduciary duties in trust law are unambiguously contractarian. The rules of trust fiduciary law mean to capture the likely understanding of the parties to the trust deal, which is why both the duty of loyalty and the duty of prudence yield to the more particularized intentions that the parties may choose to express or imply in their trust deal.[25]

The private law, contractarian nature of fiduciary duties in a commercial context make them a poor platform for the erection of regulatory structures that have interests other than those of the parties at their heart.

**Melbourne, Australia**
**July 2007**

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[24] In a sense, this is the effect of s 182 and 183 and Pt 2D.1, Div 2 of the Corporations Act in relation to a director's fiduciary duties to his or her company.

[25] J H Langbein 'The contractarian basis of the law of trusts' (1995) 105 *Yale Law Journal* 625 at 629. American fiduciary law, unlike the Australian law, includes a duty of prudence (that is, care).