Citigroup case sets precedent

ASIC's motives in bringing an action against Citigroup have wider implications than the outcome of the case, writes **Pamela Hanrahan.**

ASIC chairman Tony D'Aloisio points out that losing the action is not grounds for criticism. Photo: JESSICA SHAPIRO

The decision last week by the Federal Court to reject the Australian Securities and Investments Commission's civil claims against Citigroup Global Markets Australia is a victory for the status quo, in the investment banking context. The common (but not inevitable) practice of investment banks running both advisory and proprietary trading businesses has been upheld, with judicial confirmation that robust Chinese walls can provide an answer to the resulting legal problems of conflict management and insider trading.

The Federal Court proceedings arose out of events in late August 2005 when Citigroup was acting as adviser to the listed Toll Holdings in its takeover bid for the stevedoring company Patrick Corp. Citigroup had been trading in Patrick shares on its own account on the last business day before the bid was announced. ASIC's resulting investigation led it to allege Citigroup's proprietary trading in Patrick had breached a fiduciary duty owed by Citigroup to Toll.

ASIC argued Citigroup's actions contravened the financial services laws regulating conflicts of interest as well as the insider trading laws that prohibited any trading by the proprietary desk in the absence of an effective Chinese wall separating the "public" and "private" sides of the bank.

The legal theory underpinning ASIC's case required it to establish, first and foremost, that Citigroup owed a fiduciary duty to Toll.

Some commercial relationships — including those between trustees and beneficiaries, agents and principals, and directors and companies — are inherently fiduciary. Others may be treated as such by the courts if they have certain attributes of confidence, reliance and vulnerability — attributes that often exist between a financial adviser and its client.

An adviser that is in a contractual but not fiduciary relationship with its client owes to that client fundamental common law duties to act honestly and with care, and to keep its promises, including its promise to provide its best advice to the client. That much is clear.

Treating the relationship as fiduciary carries with it further and higher obligations, including an obligation on the adviser not to put itself in a position where its own interests might realistically conflict with its performance of those duties, unless the client has given its informed consent to the adviser being in that position.

Last week, ASIC fell at the first hurdle. The Federal Court held that, in a relationship that is potentially but not inherently fiduciary, the parties can agree as a matter of simple contract that these additional fiduciary obligations should not apply. That agreement can be invalidated by ordinary contractual flaws — mistake or misrepresentation — but not by a failure on the part of the adviser to obtain the more complex "informed" consent of the client to the surrender of the fiduciary protections to which they might otherwise have been entitled.

In defending its decision to sue Citigroup, new ASIC chairman Tony D'Aloisio quite rightly pointed out that the fact that the Federal Court's decision ultimately went against ASIC is not, of itself, grounds for criticism. A regulator that brought only those actions it knew it could win would soon be dismissed as, at best, reluctant to move in areas of legal or commercial complexity or, at worst, ineffectual.

But against that, a regulator litigating to clarify issues of law or policy needs to balance the rights of the individual firms affected by its actions. It needs a clear goal, a strong legal theory and a genuine belief that litigation, rather than its alternatives, is the only realistic way to achieve its broader aims.

ASIC has always maintained that its goal in this litigation was not to put an end the practice of investmen banks engaging in proprietary trading that may run contrary to the interests of their advisory clients, however unpalatable such a practice might seem. Rather, ASIC says, its concern was with the quality of the consent that must come from a client such as Toll, before the client can be said to have given up the additional protections that the fiduciary proscriptions provide.

In the context of ASIC's broader concerns about financial advisers and conflicts of interest, the Federal Court's decision is a telling blow. It remains to be seen whether the bigger fallout for ASIC comes not from the ire of the investment banking community, but from the precedent the case has established for contracting out of fiduciary protections in the wider investment advisory space.

■ *Pamela Hanrahan is deputy director of the Centre for Corporate Law and Securities Regulation at The University of Melbourne.*