Fiduciary Duty and the Market: Private Law and the Public Good

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ABSTRACT

One of the key goals of securities regulation is to maintain confidence in financial markets. That confidence depends in part on participants in the market believing that others act with integrity – including that securities intermediaries (such as broker/dealers, advisers and CIS operators) act in furtherance of their clients' interests, rather than their own, in discharging their functions in those markets. Securities regulators and regulatory systems have adopted various approaches to ensuring the (actual and perceived) loyalty of intermediaries to their clients' interests, including treating securities intermediaries as fiduciaries or seeking to subject them to 'fiduciary-sounding' statutory duties in relation to conflicts of interest. In Australia, the 'intermediaries as fiduciaries' approach was recently tested in Australian Securities and Investments Commission v Citigroup. *This paper argues that* ASIC v Citigroup *usefully illustrates some of the difficulties of adopting the (private) law of fiduciary duty as either a means or a model for realizing the (public) good of confidence in the integrity of securities intermediaries.*

Key words: Securities intermediaries, fiduciary duty, securities regulation, integrity systems, market confidence

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INTRODUCTION

One of the key goals of securities regulation is maintaining confidence in securities markets. Market confidence requires trust on the part of those transacting in markets that other participants act with integrity. Bound up in broader concepts of market integrity is the idea that securities intermediaries (such as brokers, dealers, advisers and CIS operators) should discharge their intermediary functions in the market in their clients' interests, rather than their own. Different systems use different mechanisms (including legal rules, regulatory policies and self-regulatory practices and codes) to achieve this end. In some jurisdictions, including Australia, fiduciary principles are increasingly being applied (or adapted) to securities intermediaries as an important means of securing the loyalty of intermediaries to their clients.

The purpose of this paper is to explore the manner in which securities regulation appropriates fiduciary concepts in its regulation of market intermediaries, with a view to opening up a more informed discussion about whether fiduciary law provides a workable conceptual model for integrity regulation for securities intermediaries.

It is clear that regulators (at least) are attracted to the ideal of the disinterested or selfless intermediary, which seems to find its best legal expression in the person of the fiduciary. After all, as Cardozo CJ famously said in *Meinhard v Salmon* 249 NY 458 (1928); 164 NE 545:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behaviour.

While the practice of fiduciary law, at least in the commercial context, is somewhat more pragmatic than Cardozo's 'punctilio of an honor most sensitive' might suggest,[1] its moral underpinnings remain constant: that a higher loyalty is owed where a person '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 the affect the interests of that other person in a legal or practical sense'.[2] As the discussion below indicates, treating securities intermediaries as fiduciaries would bind them to this higher loyalty. It signals that, in discharging their functions, they are required to have regard to their client's interests (or the client's and their joint interests) to

[1] For example, as early as 1938 Sir John Latham observed in *Mills v Mills* (1938) 60 CLR 150 at 164; 11 ALJ 527 (HCA), in relation to the application of fiduciary duties to company directors, that they are '… not, in my opinion, required by the law to live in an unreal region of detached altruism and to act in a vague mood of ideal abstraction from obvious facts which must be present to the mind of any honest and intelligent man when he exercises his powers as a director'.

[2] See *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 96-7 per Mason J (HCA).

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the exclusion of the intermediary's several interests.[3] Importantly, it also means that the intermediary is subject to the *fiduciary proscriptions* – that is, the so-called 'no conflicts' and 'no profits' rules. The effect of the fiduciary proscriptions is that, unless the fiduciary has made appropriate disclosure to its client and obtained the client's informed consent, the fiduciary is liable to account to the client for 'for any benefit or gain (i) which has been obtained or received in circumstances where a conflict or significant possibility of conflict existed between his fiduciary duty and his personal interest in the pursuit or possible receipt of such a benefit of gain; or (ii) where it was obtained or received by use or by reason of his position or of opportunity or knowledge relating to it'.[4] The nature and effect of the fiduciary proscriptions are explored in some more detail below.

While the attractions (at least to regulators) of what I might call the 'fiduciary ideal' in relation to securities intermediaries are obvious, the utility of this approach is less so. Its utility as an organizing principal for the regulation of securities intermediaries is ultimately to be decided, not so much by whether it fits with a particular conceptual framework or is consistent with orthodox understandings of the law, but by whether it works. Given the commercial nature of the relationship between the intermediary and the client, is a model that is built around 'loyalty, confidence and good faith' rather than one emphasizing 'honesty, careful conduct and keeping one's promises' the right one?[5] It is in the nature of a securities intermediary's business that it will act for other clients; it will be remunerated for its services (sometimes by its clients and sometimes by entities with whom its clients transact); and it may well transact (or be part of a conglomerate business that transacts) as a principal in the market. This is how securities markets are organized; therefore a workable scheme of integrity regulation needs to reflect this. Is a model that is primarily concerned with disclosure to, and consent by, an individual client able to deal with the implications of these structural features for broader considerations of market confidence?

These questions are considered below, in the context of the recent decision of the Federal Court of Australia in *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35; 62 ACSR 427 (FCA). It is now just over a year since Jacobson J handed down his decision in that case; a decision that attracted considerable attention in Australia and abroad.[6] In the

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[3] In 'The Fiduciary Principle', P D Finn says 'a person will be a fiduciary in his relationship with another when and insofar as that other is entitled to expect that he will act in that other's or in their joint interest to the exclusion of his own several interest': T G Youdan (ed) *Equity, Fiduciaries and Trusts* (Toronto: Carswell 1989) 46-7.

[4] *Chan v Zacharia* (1984) 154 CLR 178 at 194 per Deane J (HCA).

[5] See Lord Millett's Foreword to J McGhee *Snell's Equity* (London: Sweet & Maxwell, 30th ed 2000), distinguishing between the core concerns of equity and the common law.

[6] See eg 'Citigroup beats ASIC rap' *The Australian* 29 June 2007; 'ASIC left to lick Citigroup wounds' *Financial Times* 28 June 2007; 'Citigroup wins Australia case' *The*

Citigroup case, ASIC argued that the investment bank Citigroup owed fiduciary duties to a client in circumstances involving the provision of advice to a bidder in a contested takeover bid. ASIC argued that bank breached that duty when its proprietary trader (who was separated from the advisory team by a Chinese wall) traded in the target's shares without the express consent of the client to those trades.

A finding against Citigroup could have forced investment banks to re-examine the (profitable) practice of maintaining proprietary trading desks, and thrown into doubt the efficacy of Chinese walls as a means of managing internal conflicts of interest in financial conglomerates. However ASIC's case failed entirely. Jacobson J found that the relationship between the bank and its client was not fiduciary in character, largely because the existence of a fiduciary relationship had been expressly disavowed by the parties in the mandate letter under which the advisory services were provided. His Honour went on to say that, even if the relationship had been fiduciary, the bank's proprietary trading (which 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 considered 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.[7]

The *Citigroup* case is obviously of interest for what it says about the application of fiduciary principles to investment banks in Australia. But more broadly, the case is significant for what it reveals about how regulators, and regulatory systems, conceptualise the relationship between securities market intermediaries and their clients, and the way in which securities regulators and regulatory systems seek to use (or adapt) fiduciary principles to control and order that relationship.

I. THE GOALS OF SECURITIES REGULATION

It is helpful to begin with some preliminary comments about the goals of securities regulation.[8] Modern securities regulation has evolved to respond to perceived impediments to the effective functioning of securities markets. Underlying its concerns and design are three broad principles (each of which, it must be noted, is subject to varying degrees of contestation by lawyers, regulatory theorists and economists). The first

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Wall Street Journal 28 June 2007; 'Citigroup cleared of insider trading in Australia' *Dow Jones Business News* 29 June 2007; 'Australian court clears Citigroup of insider trading' *Agence Press France* 29 June 2007.

[7] ASIC also alleged that Citigroup contravened the insider trading laws; this claim failed also.

[8] For a comprehensive overview of the goals and pattern of Australian securities regulation, see R Baxt, A Black and P Hanrahan *Securities and Financial Services Law* (Sydney: LexisNexis Butterworths, 7th ed 2008) Ch 1.

principle is that interlocking goals of investor protection, market efficiency and systemic stability are important in the context of financial markets.[9] The second principle is that these goals are most likely to be realised when participants in markets act with integrity and there is adequate disclosure to facilitate the making of informed judgments in that market (that is, that integrity and adequate disclosure are necessary if not sufficient conditions for achieving the goals of investor protection, market efficiency and systemic stability).[10] The third principle is that market integrity and adequate disclosure would not be achieved without regulatory intervention. The need for regulatory intervention in the operation of securities markets is most often explained in the language of market failure: as arising because 'there is incomplete information or there are information asymmetries between buyers and sellers; where goods or services are 'public goods'; and where there are impacts (externalities or spillovers) on third parties that are not reflected in market prices'.[11]

The regulation of securities intermediaries fits into this broader conceptual framework. Securities intermediaries occupy a central place developed securities markets (primary and secondary), bringing together securities issuers and investors, facilitating trading, and processing and assimilating information into price. Intermediaries in developed markets include those who transact in markets on behalf of clients (such as stockbrokers and securities dealers), and those who advise clients (such as investment advisers, financial and corporate advisers, investment banks, research analysts, proxy advisors, asset consultants and the like). They also include collective investment scheme (CIS) operators: that is, investment companies, mutual funds, trustees of investment trusts and funds, responsible entities of registered managed investment schemes, trustees of pension funds and superannuation trusts, operators of exchange traded funds and the like.[12] CIS operators choose and acquire investments on behalf of members of the scheme, which are held collectively for the benefit of those members.[13]

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[9] The International Organization of Securities Commissions (IOSCO), in its *Objectives and Principles of Securities Regulation* (1998, revised 2003) recognizes as the three key objectives of securities regulation 'the protection of investors; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk'. Not all national regulatory systems embrace all three goals, or place equal emphasis on all goals. For example, the new securities laws of Singapore expressly deemphasize investor protection as a regulatory goal.

[10] The principle was is stated by the Financial System Inquiry (1997) as being that: 'financial markets cannot function effectively unless participants act with integrity and there is adequate disclosure to facilitate informed judgements': see Commonwealth of Australia *Financial System Inquiry Final Report* (1997) 235.

[11] Commonwealth of Australia *Best Practice Regulation Handbook* (2007) 60.

[12] See P Hanrahan *Funds Management in Australia: Officers' Duties and Liabilities* (Sydney: LexisNexis 2007) Ch 1.

[13] Stephen Choi says 'Intermediary institutions play a key role in interpreting disclosed information, assessing the value of companies, and collectivizing the actions of shareholders, thereby increasing investor welfare'. Stephen J Choi 'A Framework for

Securities regulation is concerned, at least in part, with ensuring that securities intermediaries act with integrity. This is driven partly by investor protection goals, reflecting a concern to protect individual clients from shirking or self-dealing by intermediaries whose services they retain. But there are also wider considerations at play. Concern that intermediaries are corrupt or self-serving, or that they exploit the information asymmetries that often arise in their relationships with clients, has potential to undermine market confidence.[14] The maintenance of public confidence in markets is essential to their effective operation, and erosion of that confidence can have a serious impact on real economies. Accordingly integrity regulation for securities intermediaries also has a role to play in relation to market fairness, efficiency and transparency, and in protecting systemic stability.

In most developed markets, securities intermediaries are subject to regulation to achieve these goals. While the coverage and intensity of regulation differs between different jurisdictions, it tends to assume a common form. Generally there is a licensing regime, which requires intermediaries to meet certain benchmarks related to competence and resources to qualify for a licence, to submit themselves to ongoing supervision by a regulator or self-regulatory agency, and to be liable to disqualification. Intermediaries will also be subject to conduct regulation, requiring them to act (or refrain from acting) in particular ways in relation to the functions they undertake. Finally, intermediaries dealing with retail clients may be subject to mandatory disclosure requirements, requiring them to disclose the nature of the service provided, the basis on which they are to be remunerated, and any information relevant to the provision of those services (such as circumstances giving rise to a material personal interest of the intermediary in matters related to the services).

Within this regulatory framework, when and how are fiduciary principles incorporated? This is considered in Part II.

II. FIDUCIARY PRINCIPLES IN SECURITIES REGULATION

Fiduciary principles turn up in securities regulation in four main ways. The first is where intermediaries are required by the securities law to be fiduciaries. The second is where (part or all of) the relationship between the intermediary and the client is within one of the established categories of fiduciary relationship, such as that between trustee and beneficiary or

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the Regulation of Securities Market Intermediaries' *Berkeley Business Law Journal* Vol 1, No 1, 2004.

[14] One of the most interesting case studies of the effect of misconduct on the part of securities intermediaries on markets and economies is the so-called Poseidon boom (and bust) in Australian in 1969. The circumstances of the boom were comprehensively recorded and analysed by the Senate Select Committee on Securities and Exchange, established in March 1970 and conducted from 1971 under the chairmanship of Senator Peter Rae (the Rae Committee). An electronic copy of the Rae Committee Report is usefully included by the Australian Takeovers Panel on its website at www.takeovers.gov.au.

agent and principal. The third is where the relationship is not within one of the established categories, but is treated by equity as fiduciary under principles of general application. The fourth is where 'fiduciary-sounding' principles (such as a proscription on conflicts of interest) are adapted and applied by statute or regulatory pronouncements to intermediaries that are not fiduciaries.

What does it mean to say that an intermediary is a fiduciary? It means that the intermediary has been given powers and discretions that it is required to exercise for the benefit of the client. Accordingly, in equity, it is required to have regard to the client's interests – and not its own – in discharging those powers and discretions.[15] To protect that obligation to act in the client's interest, equity imposes fiduciary duties on the intermediary. These are: a duty not to place itself in a position where there is a real sensible possibility that its own personal interests may conflict with its duty to exercise those powers and discretions for the client's benefit; and a duty not to use its position, or knowledge or opportunity arising from it, for its own advantage. These are the fiduciary proscriptions. Importantly, those proscriptions can be modified or excluded with the informed consent of the client. The prescriptive equitable duty – to exercise its powers and discretions in the interests of the client – governs how the intermediary must act in the discharge of its functions. The fiduciary proscriptions restrict how the intermediary may act outside of the discharge of those functions – that is, in the other things that the intermediary does. The objective is to 'preclude the fiduciary from being swayed by considerations of personal interest'[16] arising out of its other activities.

A. Intermediary must be a fiduciary

The first place that fiduciary principles turn up in securities regulation is where securities law requires that the relationship between the intermediary and the client be structured in such a way that the intermediary is necessarily a fiduciary. This is quite a common regulatory device. The clearest examples of this arise in relation to CIS operators. For example, the Australian *Corporations Act 2001* (Cth) (Corporations Act) requires that a managed investment scheme offered to retail clients be constituted as or including a trust,[17] making its operator a trustee for

[15] The intermediary must be actuated by the client's interest, but is not a guarantor of them. What matters is the intermediary's intention in exercising the power or discretion, not the result. See Lionel Smith 'The Motive, Not the Deed' *Modern Law of Real Property And Trusts - Essays For Edward Burn* (London: Butterworths 2003).

[16] *Chan v Zacharia* (1984) 154 CLR 178 at 194 per Deane J (HCA).

[17] 'Managed investment scheme' is the generic term used in the Australian legislation for collective investment schemes (other than those constituted as corporations and those, like superannuation trusts and life insurance companies' statutory funds, that are subject to prudential regulation by the Australian Prudential Regulation Authority). Generally speaking, such schemes must be registered with ASIC if they have more than 20 members or are promoted by a person in the business of promoting managed investments

investors. Similarly the Australian pensions law requires that publicly offered superannuation vehicles be constituted as trusts: see s 152(2A) of the *Superannuation Industry (Supervision) Act 1993* (Cth). In these cases the intermediary is a trustee and is clearly subject to fiduciary duties (unless they are modified or excluded by statute).

B. Intermediary is in an established category of fiduciary

The second is where the relationship between the intermediary and the client (or aspects of it) falls within one of the 'established' categories of fiduciary relationship – for example, that of trustee and beneficiary or agent and principal. This may be so where an intermediary (such as a stockbroker) holds money or assets on behalf of the client or transacts with others on behalf of the client. In these circumstances, fiduciary duties apply to the intermediary in the discharge of those functions related to the fiduciary undertaking. This may be all or only part of the relationship between the intermediary and the client. As Le Meire J observed in *Price v Powers* [2005] WASC 154 at [48], it is not enough to establish merely that the particular relationship can be described as fiduciary. It is necessary to go beyond that to establish the precise scope of the fiduciary obligation within that relationship:

> One person may be in a fiduciary position with respect to a part of his activities and not with respect to other parts (*New Zealand Netherlands Society 'Oranje" Inc v Kuys* [1973] 1 WLR 1126 per Lord Wilberforce) and one relationship may involve both fiduciary and non-fiduciary obligations (*Kelly v C A & L Bell Commodities Corp Pty Ltd* (1989) 18 NSWLR 248 per Mahoney JA at 256).

It may be in a particular case that the fiduciary proscriptions apply with respect to the discharge by the intermediary of some of its functions but not others.

C. Intermediary is treated as a fiduciary under equitable principles

The third is where an intermediary does not fall within one of the established categories of fiduciary (such as trustee or agent) but the circumstances of its relationship with its client are such that it should be treated in equity as a fiduciary. This is the most difficult category, particular when it is applied to advisers and investment banks. In Ch 15 of the new edition of *Securities and Financial Services Law* (Sydney: LexisNexis 2008, forthcoming) my co-author Ashley Black concludes that:

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schemes, if they have offered or issued interests to investors in circumstances that would require disclosure to investors under Pt 7.9 of the Corporations Act: see CA s 601ED. In a registered scheme, the operator of the scheme (called the 'responsible entity') is deemed by statute to hold scheme property on trust for the members of the scheme: see CA s 601FC(2).

> a relationship may be fiduciary in character if the [intermediary] undertakes or agrees to act for or on behalf of or in the interests of its client in the exercise of a power or discretion which will affect the interests of the client in either a legal or practical sense, so that the financial services licensee has a special opportunity to exercise that power or discretion to the detriment of its client who is therefore vulnerable to abuse by the financial services licensee of its position: *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 96 per Mason J; *News Ltd v Australian Rugby Football League Ltd* (1996) 64 FCR 410 at 538; 21 ACSR 635; *ASIC v Citigroup Global Markets Australia Pty Ltd* (2007) 160 FCR 35; 62 ACSR 427 at [292]. In particular, a fiduciary relationship may arise between a financial adviser and a client where the adviser holds itself out as an expert on financial matter and undertakes to act in the client's interests and not solely in its own interests: *Daly v Sydney Stock Exchange Ltd* supra at 377 per Gibbs CJ, 385 per Brennan J (stockbroker), *Commonwealth Bank of Australia v Smith* (1991) 42 FCR 390 at 391; 102 ALR 453 (trading bank), *Aeqitas v Sparad No 100 Ltd (formerly Australian European Finance Corporation Ltd)* (2001) 19 ACLC 1006 at [301], [310] (corporate adviser).[18]

However, Black rightly urges caution before a relationship between a securities intermediary and its client is too readily characterised as fiduciary, 'since that relationship arises in a business context in which customers may be expected to understand that financial services licensees are seeking to promote the sale of their financial products or financial services, and to expect honesty rather than a lack of self-interest in that context'.[19] He notes that, by way of comparison, 'American and Canadian authorities generally do not treat the relationship of a stockbroker or futures broker and its client as fiduciary per se, but have held that fiduciary obligations may arise if the client is unsophisticated or the financial intermediary conducts a discretionary account on behalf of the client, or where the client relies on the intermediary's expertise and judgment in entering the market or making trading decisions' (footnotes omitted).

In *ASIC v Citigroup*, above, Jacobson J concluded that the relationship between an investment bank and its client (the bidder in a takeover bid, to whom the bank was providing advice) was not fiduciary. The *Citigroup* case is discussed in detail elsewhere.[20] For reasons to do with the way the

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[18] Baxt, Black and Hanrahan, above n 8, Ch 15.

[19] Referring to D C Langevoort, 'Selling Hope, Selling Risk: Some Lessons for Law from Behavioural Economics about Stockbrokers and Sophisticated Customers' (1996) 84 *California LR* 627.

[20] See P Hanrahan '*ASIC v Citigroup:* Investment Banks, Conflicts of Interest and Chinese Walls' in J O'Brien (ed) *Private Equity, Corporate Governance and the Dynamics of Capital Market Regulation* (London: Imperial College Press, 2007) 117-142.

case was argued before the Federal Court, ASIC needed to establish that the relationship between Citigroup (the intermediary) and Toll Holdings Ltd (the client) was fiduciary in character. In this regard Jacobson J was referred to an article 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.[21]

In the *Citigroup* case the relationship between Citigroup and Toll arose under a mandate letter which included an express stipulation that the relationship was not fiduciary. Specifically, the mandate letter included the following sentence:

> 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.

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. This, in effect, created 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.

As to the first issue, Jacobson J concluded 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'. The basis upon which his Honour 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'.

As to the second issue, his Honour concluded that the contractual stipulation was effective to preclude the relationship between Citigroup and Toll from being treated as fiduciary. His Honour confirms, at [307], 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. However this principle (that fully

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

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]). 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.[22] 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.

D. Fiduciary-sounding duties are incorporated into statute

The fourth way in which fiduciary principles turn up in securities regulation is where they are 'co-opted' into statute or regulatory policy. Here the intention is not to make the intermediary a fiduciary, but rather to impose 'fiduciary-sounding' obligations on the intermediary. Most often this appears as a control on 'conflicts of interest'. For example, s 912A(1) of the Corporations Act, which sets out the basic duties of securities intermediaries who hold (as most are required to) an Australian financial services licence, includes an obligation 'to have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business of the licensee or the representatives': CA s 912A(1)(aa). Regulations covering similar subject matter can be found in many jurisdictions.[23]

There are, of course, many things that can be said about the difficulty of picking up legal words that have a specific meaning in one context and putting them, apparently without any real reflection, into another context – perhaps the kindest is that it rarely works. ASIC has published extensive guidance on what it believes that s 912(1)(aa) requires, in ASIC

[22] 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.

[23] Conflicts of interest, at least for investment advisers, are subject to regulation in most jurisdictions. ASIC's Regulatory Guide 181 identifies conflict regulation in: United States (common law duty, s206 of the *Investment Advisers Act* and Rule 204–3 ('Brochure Rule')); Canada (common law duty, and s40 and s223(1) of the *Securities Act*); United Kingdom (common law duty, Financial Services Authority *Handbook,* Conduct of Business, Section 7.1); Hong Kong (common law duty, para 10.1 of the *Code of Conduct for Persons Registered with the Securities and Futures Commission*); and Singapore (common law duty, s27 of the *Financial Advisers Act*). Presumably the reference to 'common law' is to include equity.

Regulatory Guide 181 (30 August 2004). Its views appear to suggest little connection between the 'no conflicts' rule as it is understood in fiduciary law, and the statutory provision. ASIC defines conflicts of interest for the purposes of the policy as 'circumstances where some or all of the interests of people (clients) to whom a licensee (or its representative) provides financial services are inconsistent with, or diverge from, some or all of the interests of the licensee or its representatives. This includes actual, apparent and potential conflicts of interest': see [RG 181.15].[24] In other words, ASIC Regulatory Guide 181 is directed at situations where the intermediary and the client have divergent commercial interests – conflict of *interest and interest*. This seems qualitatively different from fiduciary understandings of conflicts, which are said to arise in circumstances where the untrammelled pursuit by the intermediary of its own interests might reasonably come into conflict with its duty to discharge its functions in the interests of the client – that is, conflict of *interest and duty*.

In ASIC's view, conflicts of interest (as defined) are managed through one or more of: controlling, avoiding or disclosing the conflict. ASIC says at [RG 181.27] that 'many conflicts of interest can be managed by a combination of: (a) internal controls (see [RGS 181.28]–[RGS 181.41]); and (b) disclosures (see [RG 181.49]–[RG 181.63]). However in its view some conflicts cannot be managed in this way: 'where conflicts cannot be adequately managed through controls and disclosure, the licensee must *avoid* the conflict or refrain from providing the affected financial service: see [RG 181.42]–[RG 181.43]'.

ASIC relied on CA s 912A(1)(aa) in the *Citigroup* case.[25] ASIC argued that Citigroup had breached its statutory duty *in that* it owed a fiduciary duty to Toll which it had not discharged. Because its case was constructed in this way, ASIC's failure to establish that the relationship between Citigroup and Toll was fiduciary necessarily meant that there was no breach of CA 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.

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[24] For example, ASIC treats situations where a representative of the licensee has an inconsistent or divergent commercial interest from its client as being a 'conflict of interest' that attracts the operation of CA s 912A(1)(aa).

[25] In the event, it was not able to do so because, for technical reasons, Citigroup (although an AFS licensee) was not subject to CA s 912A(1)(aa) in this instance: see (2007) 160 FCR 35; 62 ACSR 427 at [440]. 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.

Despite ASIC's inability, at least in its pleadings, to find any content for CA s 912(1)(aa) in the absence of a fiduciary relationship between the intermediary and the client, Jacobson J did go on to make some (limited) comments about what might amount to the adequate management of conflicts in these situations, in the contemplation of a provision like CA 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[26] 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].

III. THE LIMITATIONS OF THE FIDUCIARY MODEL

The foregoing discussion demonstrates some of the ways in which fiduciary principles are incorporated into securities regulation; in so doing it alludes to some of the technical and practical difficulties of having statutory and equitable principles that operate alongside each other, particularly where the application of equitable principles and the intended relationship with the statute is not perfectly clear. Those difficulties have been well canvassed elsewhere. While obvious, and complex, these difficulties are not insurmountable. Here, my concern is slightly broader than these technical issues. I said at the beginning that the purpose of this paper was to open up a discussion about whether the 'fiduciary ideal' is the right *conceptual* model for the regulation of securities intermediaries. In other words, what kinds of theoretical considerations might come into play in deciding the utility of requiring securities intermediaries to be, or otherwise treating them as, fiduciaries? Does it throw up difficulties, other than technical ones to which I have referred, for the design of integrity regulation that might prove to be more intractable?

It seems to me that the *Citigroup* case suggests that the fiduciary ideal has two important limitations as an organizing principle for the regulation of securities intermediaries. First, the fiduciary proscriptions can be modified or excluded with the informed consent of the client – and the and this may not be consistent with the regulatory goals of protecting

[26] 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 *Fiduciary Duties and Regulatory Rules*, Consultation Paper No 124 (1992) at [4.5] and Report No 236 (1995), and by Lord Millett in *Prince Jefri Bolkiah v KPMG* [1999] 2 AC 222. See also C Hollander and S Salzedo, *Conflicts of Interest and Chinese Walls* (London: Sweet & Maxwell, 4th ed 2004). Chinese walls do not, of themselves, eliminate conflicts of interest and duty. However as Jacobson J notes at [315] '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'.

market confidence as well as individual investors. Secondly, the way in which the (private law) fiduciary principles work – that is, how they are interpreted and applied, and by whom – may not be wholly congruent with the project of regulation.

A. The consent issue

Although ASIC's motives for bringing proceedings against Citigroup in relation to the Patrick takeover remain unstated,[27] it seems unlikely that the regulator was motivated primarily by a desire to protect Toll. Toll, as a sophisticated commercial party surrounded during the takeover by a phalanx of advisors, would seem an unlikely candidate for the solicitude of the regulator (or, for that matter, of a court of equity). It seems reasonable to assume that, in this case, ASIC's primary concern was with implications of Citigroup's proprietary trading for the *market*, rather than the client. It might well (although this is just speculation) have thought that the market would be uncomfortable that an investment bank that had been retained to advise a client in connection with a takeover could engage in proprietary trading in the lead-up to the bid seemingly in competition with the bidder. It may have been concerned that such a practice, particularly if it was not well understood by other market participants, could undermine confidence in the integrity of the market.

If this is so, then the decision clearly demonstrates the limitations of using fiduciary principle as a mechanism to protect the integrity of the market (as distinct from the position of the individual client). Because Citigroup's functions under the mandate did not bring it with the established categories of fiduciaries, it and Toll were able to prevent any fiduciary relationship arising between them by ordinary contractual consent. Even if the relationship had been within one of the established categories, the fiduciary proscriptions[28] could have been modified or excluded with the informed consent of the client. There is (quite appropriately, of course) no requirement on either party to take into account the interests of the market in deciding whether fiduciary duties should be excluded, or to communicate that fact to the market. If there is a broader *market* imperative (for example, to do with market confidence) as to why intermediaries should not be able to act in situations of conflict

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[27] For a discussion of ASIC's public statements at the time the litigation was commenced, see P Hanrahan 'Conflicts of Interest in Investment Banks and Conglomerates: Citigroup and the Australian Securities and Investments Commission', seminar presented at The University of Cambridge on 15 November 2006 as part of the Cambridge Finance Transatlantic Financial Services Regulatory Dialogue Seminar Series 2006/7

[28] But probably not the 'equitable obligation proper' of the fiduciary to exercise its powers and discharge its functions in good faith in the interests of the client, and for a proper purpose: see Hanrahan, above n 12, [2.79]. For a detailed discussion of when a trustee's prescriptive and proscriptive duties can be modified or excluded with the consent of the beneficiary, see also P Hanrahan 'The Responsible Entity as Trustee' in Ian Ramsay (ed) *Key Developments in Corporate Law and Trust Law: Essays in Honour of Professor Harold Ford* (Sydney: LexisNexis 2002).

or to retain profits derived from their position, then private law fiduciary concepts will not achieve that, because of the autonomy they give to the parties to exclude them. Instead a parallel statutory scheme (such as we have for company directors in Div 2, Pt 2D.1 and Ch 2E of the Corporations Act) that cannot be excluded may be required. If the intention of CA s 912A(1)(aa) was to achieve this result, it has not done so.

The disclose-and-consent model on which fiduciary law is based may also have limitations as an investor protection mechanism. Intermediaries whose activities fall outside the established categories of fiduciaries will elect to contract out of such duties arising – and in the absence of contractual defects such as mistake or duress this contracting out will be effective. Where the intermediary is a fiduciary, modifying or excluding the fiduciary duties requires the higher level of 'informed consent'. But even so, the fact that the intermediary has obtained the informed consent of the client may not actually achieve broader policy goals. In other words, there may be inherent limitations in a disclose-and-consent regulatory model.[29]

B. Private law and interpretation

I also wonder whether the Citigroup case demonstrates conceptual difficulties arising from co-opting or enlisting private law concepts into regulatory regimes. For example, we know that fiduciary law is entirely specific in its application – that is its strength. As Mason J observed in *Hospital Products*, above, at 82 'it is now generally acknowledged that the scope of the fiduciary duty must be moulded according to the nature of the relationship and the facts of the case'. In private law it is for the parties to that relationship to determine the scope of the duty, and what it requires, having regard to the particular character and terms of the relationship between them. In effect, the 'interpretative space' in which the law operates is occupied by those two parties only, with a court becoming involved, if at all, only at the behest of one of the parties. In regulation the situation is different. Others occupy the interpretative space, including regulators and other regulated entities, that have an impact in deciding what the duty requires. The work of Bottomley and others suggests this may be significant.[30] Further, the approach to how the duties are to be understood and applied may be different in private law – private law values or perspectives may come to override the 'public regarding' values underpinning regulation.[31]

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[29] See eg S M Bainbridge, 'Mandatory Disclosure: A Behavioral Analysis' . *University of Cincinnati Law Review*, Vol. 68, pp. 1023-1060, Summer 2000.

[30] See S Bottomley 'A Framework for Understanding the Interpretation of Corporate Law in Australia' in S Corcoran and S Bottomley *Interpreting Statutes* (Sydney: Federation Press 2005) Ch 9.

[31] D Kingsford Smith 'Interpreting the Corporations Law – Purpose, Practical Reasoning and the Public Interest' (1999) 21 *Sydney Law Review* 161.

CONCLUSION

In *ASIC v Citigroup*, the Australian securities regulator sought to impose on a investment bank the proscriptive duties of a fiduciary in relation to the bank's dealing with its advisory client. Clearly the decision is of interest for what it says about fiduciary law - the bases upon which a commercial relationship that falls outside the established categories may be treated as fiduciary, the proper application of the fiduciary proscriptions (in particular, the 'no conflicts' rule), and the effect of obtaining the consent of the person to whom duties are owed on the operation of the proscriptions. But this paper argues that the *Citigroup* case is also significant because of what the decision to take the action says about the approach of the regulator to the relationship between an intermediary and its client. It signals that the regulator favours a conceptual model of that relationship that requires and invokes the protections of the fiduciary proscriptions. Put another way, it could be said that the regulator thinks of the business of securities intermediaries as a profession, rather than a trade. This paper invites discussion of whether this is a useful approach for regulators and regulatory systems to take.