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ASIC v Citigroup: An Amber Light For Proprietary Trading

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Abstract
Investment banks breathed a sigh of relief when the Federal Court dismissed ASIC's claims in ASIC v Citigroup Global Markets Australia Pty Limited (No 4) [2007] FCA 963. But Citigroup was not an unqualified affirmation of current proprietary trading practices. It highlights several important risks of which investment banks should be aware when advising clients in takeover situations.

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ASIC v CITIGROUP: AN AMBER LIGHT FOR PROPRIETARY TRADING

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Investment banks breathed a sigh of relief when the Federal Court dismissed ASIC's claims in *ASIC v Citigroup Global Markets Australia Pty Limited (No 4)* [2007] FCA 963. But *Citigroup* was not an unqualified affirmation of current proprietary trading practices. It highlights several important risks of which investment banks should be aware when advising clients in takeover situations.

INTRODUCTION

Investment banks breathed a sigh of relief when the Federal Court dismissed ASIC's claims in *ASIC v Citigroup Global Markets Australia Pty Limited (No 4)*[1] ('*Citigroup*'). ASIC's allegations of breaches of fiduciary duty and insider trading went to the heart of how investment banks operate when advising a party to a takeover.

Many commentators have applauded how *Citigroup* affirmed current practices of investment banks. Certainly, the case affirmed the legal basis upon which investment banks contract out of fiduciary duties, as well as the effectiveness of 'Chinese walls' as a means of dealing with potential conflicts. The case also imports English authority on what courts consider to be the characteristics of an effective 'Chinese wall'.

A close analysis of the case reveals that to call it an unqualified win for investment banks may be premature. Citigroup was saved by a key finding that no fiduciary relationship existed between it and its client. Once that finding was made, most of ASIC's claims collapsed. As will be seen, the Court's conclusion that no fiduciary relationship existed was based on a generous concession by ASIC, as well as facts peculiar to Citigroup's client that can readily be distinguished in future cases.

Background and key facts

Citigroup Global Markets Australia Pty Limited ('Citigroup') is the Australian arm of Citigroup Inc, a global financial services company. Citigroup's business is conducted through various divisions, which include investment banking and equities trading. In order to conduct its business, Citigroup holds an Australian financial services licence.

Citigroup employees who work in investment banking are exposed to confidential, market sensitive information. This side of the business is called 'private side'. Other employees work in areas such as equities trading, and are not exposed to confidential information – this is known as 'public side'. In accordance with standard market practice, Citigroup

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[1] [2007] FCA 963.

established 'Chinese walls' to restrict the flow of information from the 'private side' to the 'public side'. The characteristics of Citigroup's 'Chinese walls' are summarised in paragraph 449 of the decision. Part of Citigroup's public side involves the bank's internal trading house buying and selling securities using the bank's own funds. This is known as 'proprietary trading'.

On 19 August 2005, a trader in Citigroup's proprietary trading division (public side) caused the bank to purchase over one million shares in Patrick Corporation Ltd ('Patrick'). This heavy trading drove Patrick's share price up substantially.

Unbeknownst to the trader, Citibank's private side was advising Toll Holdings Ltd (Toll) in relation to a possible takeover attempt of Patrick. The terms of Citigroup's relationship with Toll were set out in a mandate letter executed on 8 August 2005. However Citigroup had been assisting Toll since January 2005, and – importantly – had effectively secured the mandate to advise on the takeover by June 2005.

A private side employee discovered that Citigroup's public side had purchased Patrick shares. The public side was told to stop buying them, but not the reason why. Shortly after the conversation, the public side trader sold 20% of the Patrick shares that had been purchased.

ASIC's claims

ASIC made four claims against Citigroup.

First claim: Breach of fiduciary relationship

ASIC alleged that Citigroup had a fiduciary relationship with Toll. By purchasing the Patrick shares, Citigroup had placed itself in a position where its duty of loyalty to Toll conflicted with its own interests. As a prospective bidder for Patrick, it was in Toll's interests for the price of Patrick shares to remain low. Citigroup, as owner of the Patrick shares, had an interest in seeing their price rise. In the context of Toll's proposed takeover, it had an interest in Toll making as high a bid as possible.

Second claim: Citigroup did not have 'adequate arrangements' in place to manage conflicts

ASIC argued that, as a necessary consequence of Citigroup's breach of its fiduciary duties to Toll, the bank had breached s 912A(1)(aa) *Corporations Act*, which requires financial services licensees to have in place adequate arrangements for the management of conflicts of interest.

Third claim: Misleading and deceptive conduct

In the alternative to its second claim, ASIC argued that Citigroup breached s 1043H *Corporations* Act and s 12DA of the *ASIC Act*, both of which prohibit misleading and deceptive conduct. The misleading conduct was said to arise from Citigroup's failure to inform Toll that it had acquired a substantial quantity of Patrick shares.

Fourth claim: Insider trading

ASIC also made two claims against Citigroup of contravention of the insider trading provisions in s 1043A of the *Corporations Act*. The first claim was in relation to the proprietary trader's sale of the Patrick shares, which occurred following his instructions not to buy those shares. ASIC alleged that as a result of what was said to him, the trader must have deduced that Citigroup was acting for Toll in the proposed takeover of Patrick.

The second insider trading claim covered all of the trading in Patrick shares undertaken by Citigroup on 19 August 2005. ASIC alleged that senior officers of the Investment Banking (private) division of Citigroup knew that there was a substantial likelihood that Toll would launch its takeover bid the day after the shares were purchased. As the *Corporations Act* attributed this knowledge to Citigroup as a whole, the bank was therefore liable for insider trading.

The decision

The Court rejected all of ASIC's claims.

First claim: Citigroup and Toll were not in a fiduciary relationship

The Court noted that while the relationship between the investment bank and a client in a takeover was not one of the defined classes of fiduciary relationships, relationship had many fiduciary aspects, and would in the ordinary course be considered a fiduciary one.

Most aspects of a fiduciary relationship (apart from fraud or deliberate dereliction of duty) can be excluded by an appropriately worded contract. It is particularly easy to do so where no prior fiduciary relationship existed between the parties, and the contract defines the rights and duties of the parties.

Here, the contract between Citigroup and Toll (in the form of the mandate letter) provided that Citigroup was to act 'as an independent contractor and not in any other capacity including as a fiduciary'. Importantly, ASIC conceded that no fiduciary relationship had arisen between Citigroup and Toll prior to the execution of the mandate letter – despite the parties having been in a relationship since January 2005, and Citigroup having effectively received the mandate in June 2005.

The Court accepted ASIC's concession. It found that the mandate letter successfully excluded a fiduciary relationship between the parties.

Second claim: Citigroup had 'adequate arrangements' in place to manage conflicts

As the Court had found that Citigroup and Toll were not in a fiduciary relationship, it followed that ASIC's second claim, which was based upon this assumption, had to fail. Nevertheless, the Court examined Citigroup's arrangements for the management of conflicts of interest (its 'Chinese walls') and was satisfied that they were adequate. While cautioning that 'adequate arrangements' required more than a 'raft of written policies and procedures', the Court found the following were key aspects of an effective 'Chinese wall':

a) physical separation by departments;

b) educational programmes (that are regularly repeated);

c) procedures for dealing with 'crossing the wall';

d) monitoring by compliance officers; and

e) disciplinary sanctions for breaching the wall.

Third claim: Citigroup did not engage in misleading and deceptive conduct

As the Court had decided that Citibank and Toll were not in a fiduciary relationship, ASIC's claim in this respect had to fail, because Citibank was under no obligation to inform Toll of its trading. The bank's silence could not constitute misleading and deceptive conduct.

Fourth claim: Citigroup did not engage in insider trading

ASIC's first insider trading claim was that Citigroup had engaged in insider trading when the public side sold some of the Patrick shares he had purchased, while in possession of 'inside information'. ASIC alleged that once the trader was told to stop buying Patrick shares, he must have deduced that Citigroup were acting in a takeover bid for the company. This deduction was the 'inside information'.

In order to make Citigroup liable for inside trading, ASIC needed to show that the trader was an 'officer' of Citigroup. Only as an officer would his knowledge would be attributed to Citigroup.

The Court found that ASIC had not proven that the trader had made the necessary deduction that Patrick would be the subject of a takeover bid, and in any event the inside information was not even 'price sensitive' because the market (which was awash with rumours) had already taken the possible takeover into account in the share price. Finally, the trader was not an 'officer' of Citigroup. That meant that even if he had made the deduction, it would not have been attributable to Citigroup, and the bank could not have been prosecuted for insider trading.

ASIC's second insider trading claim focussed on Citigroup's purchases and sales of Patrick shares throughout the day's trading on 19 August 2005. The substantial question the Court had to consider was whether on that day, Citigroup had arrangements in place that could be reasonably expected to ensure that confidential information was not communicated from the private to the public side of the business.[2] The Court concluded that they were adequate, and therefore the second insider trading claim failed.

ASIC has indicated that it will not appeal the decision.[3]

Analysis

Despite Citigroup's success in this case, it is not simply a 'green light' for investment banks. It highlights a number of risks to which the banks should pay heed.

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[2] *Corporations Act 2001* (Cth) s 1043F. In other words, whether Citigroup's Chinese walls were an adequate arrangement, within the meaning of s 1043F(b).

[3] <http://www.asic.gov.au/asic/asic.nsf/byheadline/07-193+ASIC+v+Citigroup?openDocument> at 28.07.2007.

ASIC's first, second and third claims collapsed once the Court decided the mandate letter successfully excluded the existence of a fiduciary relationship. That was in circumstances where ASIC conceded that there was no pre-existing fiduciary relationship between the parties at the time the mandate letter was executed.[4] ASIC's concession may have been premature, because the Court observed that the pre-contractual dealings between Toll and Citigroup 'contained all of the indicia of a fiduciary relationship of adviser and client'.[5] That the pre-contractual dealings exhibited a fiduciary character is not surprising given that Citigroup had effectively secured the mandate to act for Toll in June 2005 (the mandate letter was not executed until August).

The fiduciary character of the parties' pre-contractual relationship included Citigroup's giving advice to Toll on the takeover concerning the wisdom and merits of making a bid for Patrick, the pricing of the offer and calculation of the premium.[6] The advice involved the use of (and Toll's reliance upon) Citigroup's financial acumen, judgment and expertise.

What if ASIC had argued that there was a pre-existing fiduciary relationship?

Given the Court's observations above, Citigroup may have had difficulty convincing the Court that there was no fiduciary relationship between it and Toll prior to execution of the mandate letter.

If Citigroup had in fact failed in this argument, then for the mandate letter to successfully displace the fiduciary relationship (as it purported to do) Citigroup would have had to show that it had obtained Toll's fully informed consent.[7] 'Fully informed consent' involves full and frank disclosure of all material facts, but it can be implied.

The Court found that if a fiduciary relationship had existed, Toll would have impliedly given consent to the breach of fiduciary duties by virtue of its knowledge of Citigroup's structure and method of operations, and experience and 'core competency' in mergers and acquisitions.[8]

The Court rejected a submission that fully informed consent could be implied in all cases where an investment bank advising on a takeover trades in its client's target's shares.[9] Rather it depends upon the circumstances of each case.

Consent is unlikely to be implied in the case of companies less versed in takeovers and investment bank practices than Toll. In the case of a less-experienced company, the terms of a mandate letter like that used by Citigroup would not have successfully excluded the bank's fiduciary duties to its client. This highlights a real risk for an investment bank advising a client in a takeover, where the client is inexperienced in takeover situations and unfamiliar with the practices of investment banks.

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4 *Citigroup* at [306].

5 Ibid at [326].

6 Ibid at [327].

7 *Commonwealth Bank of Australia v Smith* [1993] 42 FCR 390.

8 *Citigroup* at [355].

9 Ibid at [359]-[360].

Narrower interpretation of 'officer'

The case also potentially narrows the application of the definition 'officer', as that role is defined in the Corporations Act 2001.

ASIC submitted that the proprietary trader was an 'officer' of Citigroup because he 'had the capacity to affect significantly the corporation's financial standing': this is one of the three definitions set out in the Corporations Act.10 In fact, he was authorised to make trades up to $10 million per day. The Court disagreed with ASIC, and decided that for a person to be an 'officer' of a corporation, he or she must also be 'involved in policy making and decisions that affect the whole or a substantial part of the business of the corporation'.11

This effectively narrows the definition of 'officer', given that the Corporations Act contemplates no such qualification. This aspect of the decision will be welcomed by banks and other entities that employ people to make significant financial decisions on their behalf (but who are not involved in management or broader business decisions).

Conclusion

Citigroup is not an unqualified affirmation of current practices. Properly analysed, it is a warning of the risks inherent in investment banks' current practices. Citigroup escaped sanction for two reasons. Firstly, ASIC conceded that no fiduciary relationship existed between Toll and Citigroup prior to the mandate letter. That appears to be a strange concession, given the Court found the pre-contractual dealings between Toll and Citigroup contained all of the indicia of a fiduciary relationship of adviser and client.

If ASIC had successfully argued that a fiduciary relationship existed prior to the mandate letter, then Citigroup would still have succeeded – because Toll gave implied consent to Citigroup breaching its duties, given Toll's experience in takeovers and investment bank practices. The Court specifically rejected a submission that fully informed consent could be implied in all cases where an investment bank advising on a takeover trades in its client's target's shares. It is unlikely that many companies will have as much experience as Toll in the area of mergers and acquisitions: Toll has undertaken more than 40 acquisitions since 1989; an average of over 2 per year.

To exclude the potential risks highlighted by this case, investment banks should consider the following precautions when acting in a takeover transaction:

a) The bank should contract with its client on the basis that its fiduciary duties are expressly excluded. This contract should be executed at the commencement of the bank's relationship with the client, before the bank provides any advice to the client.

b) If the contract cannot be executed at this time, the bank may already owe the client fiduciary duties. The bank must obtain the client's consent to waive these duties, which can be express or implied.

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[10] *Corporations Act 2001* (Cth), s 9.

[11] *Citigroup* at [490].

c) Consider whether the client has a 'core competency' in takeovers, and is familiar with the business practices of investment banks. The Court decided that Toll's 'core competency' in acquisitions arose because 'a substantial part of Toll's business strategy has been to make acquisitions of rival and complementary businesses', and 'a large part of its business has been built through mergers and acquisitions'.

d) If the client does not have a 'core competency' in takeovers and a familiarity with business practices of investment banks, the bank should not assume that the client has impliedly given informed consent to a breach of fiduciary obligations. The bank must seek the client's express and fully informed consent to engage in proprietary trading in the target's shares.

e) Until consent is obtained, the proprietary side of the bank must be prohibited from trading in the target's shares. Unfortunately this carries with it an inherent risk: an uncommunicated supposition, such a deduction or inference made by an individual on the basis of a 'hint', can constitute 'insider information'. If a proprietary trader is ordered not to trade in a certain company's shares, and he/she deduces 'insider information' from that order, then he/she cannot trade in those shares without breaching the insider trading provisions of the *Corporations Act*.[12] The only solution may therefore be an outright prohibition on the proprietary traders trading in the shares.

f) If the client does appear to have a 'core competency' in takeovers and familiarity with investment banking practices, the client's consent to the bank's proprietary trading in the target's shares may be implied. This is inherently risky, given the lack of guidance on what constitutes a 'core competency' in takeovers. In any event, if a client is sophisticated enough to meet this threshold, they may not object to giving an express, fully informed consent. This will always be safer than relying upon an implied consent.

[12] *Hannes v Director of Public Prosecutions (Cth) (No 2)* [2006] NSWCCA 373; *Citigroup* at [537]-[538].