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Key Issues

This note addresses the following:

- Defining conflicts of interest, and why they are important
- Understanding fiduciary duties and how they “up the ante” on conflicts
- Considering some psychology about conflicts of interest
- Understanding how conflicts can arise in the context of financial services
- International regulatory responses to conflicts of interest
- When should you be alarmed?

Background

What are Conflicts of Interest?

In general, a conflict of interest is where a person is serving two or more interests, and can (but does not necessarily) put one interest in a better position at the expense of the other. There is no universally accepted definition of conflicts of interest, even in the regulatory context of many jurisdictions.

Conflicts of interest can arise in any number of situations and sectors, and usually arise due to an asymmetry, or imbalance, of information between the two parties.

Why do Conflicts of Interest Matter?

Conflicts of interest can lead to adverse selection, where a client does not receive the best or most appropriate advice or services, or moral hazard, where one party to the transaction fails to act in good faith.

In addition, the existence or abuse of conflicts of interest can severely affect the trust that consumers have in the system. Confidence in the integrity of those managing assets, investments, and the financial futures of ordinary people is crucial to its operation.

From a regulatory perspective, the U.S. Securities and Exchange Commission (SEC) has in the recent past identified it as a priority for focus:

... [the SEC has] identified conflicts of interest as a key area for our risk analysis. This is based on the long experience of our exam program that conflicts of interest, when not eliminated or properly mitigated, are a leading indicator of significant regulatory issues for individual firms, and sometimes even systemic risk for the entire financial system.

Carlo V. di Florio, Director, Office of Compliance Inspections and Examinations, SEC (October 22, 2012)

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1 This note was prepared by Karen Den-Toll on behalf of Toronto Centre.
When Do Conflicts of Interest Become a Problem?

It’s important to understand that the existence of conflicts of interest is not, of itself, the problem. A conflict of interest is merely a set of circumstances that has the potential to cause loss or detriment to a party, or unfairly acquired gain to another.

Problems arise when actions are taken in a situation where a conflict of interest exists, and those actions and their consequences amount to a breach of duties or advantage gained by the person taking the action. They can also be problematic when there is the perception of a problem, even if no detrimental action is taken. For this reason, the proper management of conflicts of interest would consider both actual and perceived conflicts (a.k.a. the “smell test”).

In practice, some people can take offence at being informed that they have a conflict of interest, as they can feel they are being accused of doing something wrong or being unable to differentiate between right and wrong. An alternative, possibly more palatable, way of referring to the issue is a “conflict of duties”.

Conflicts are particularly troublesome when they are not visible, or when the incentive to act against the client’s interest far outweighs the incentive to act for them.

Fiduciary Duties

The existence of a fiduciary relationship between two parties increases the legal and moral burden on the fiduciary. In cases where one party to a relationship owes fiduciary duties to the other in financial services, the potential for the incidence of conflicts of interest can be higher (due to the commercial arrangements involved), and the consequences of a misuse of power can be more devastating, due to the levels of trust and confidence inherent in such situations.

Fiduciary duties are the strictest duty of care in the common law legal framework, and have developed out of centuries of legal history. In civil law countries, although fiduciary duties per se do not exist since the law is written rather than created over time by judicial interpretation, in many cases regulation essentially imposes very similar obligations. This paper considers the common law position.

It is important to note that fiduciary duties arise from private law/contracts, and not from regulation, although some countries have codified some or all of the duties as they apply to specific relationships (such as in pension laws). It is also worth noting that, although based on the same origins in English law, different common law countries may interpret the duty slightly differently due to divergences in case law over time.

Fiduciary duties are characterized by trust and confidence, although there are a number of factors that are taken into account to establish whether a fiduciary relationship exists. Where fiduciary duties exist, a person (the fiduciary) is to act in the interests of another person (the principal), and not in their own interests. Fiduciary relationships exist in a number of contexts, generally where one person handles money or property on behalf of another, including between:

- directors and the company (not the shareholders)
- trustees and beneficiaries
- brokers and principals (in the case of insurance, the broker is the client)
- agents and principals (in the case of insurance, the principal is the insurer)
- attorneys and clients
• between partners, or participants in a joint venture (unless such duties are otherwise excluded by agreement, which is common)
• liquidators and creditors/the company/members
• employees and employers (although employees will not generally be regarded as full-blown fiduciaries of their employer, certain circumstances may arise that places an employee in a position where they have some fiduciary obligations such as the duty to act honestly, and not to profit him or herself to the detriment of the employer).

Whether someone is a fiduciary depends on the understanding and circumstances of the parties in the relationship. In many cases, the parties may contract out of such a duty where the law does not prohibit it, or where it would not inherently change the required relationship (for example, a trust relationship is always fiduciary; if it were not, it would not be a trust). A question to ask in identifying whether there is a fiduciary relationship is: Can the principal reasonably expect that the representative will act in the principal’s best interests, and not in their own interests, even to the detriment (or lack of enrichment) of the representative?

The duties of the fiduciary fit under the following general themes:

• **Loyalty** – To avoid conflicts, to not profit from the principal (unless there is fully informed consent); to act in the best interests of their principal, even to the detriment of their own interests.
• **Prudence** – The fiduciary must take reasonable care for the assets in the fiduciary’s care.

In some countries, a fiduciary is also obliged to act in good faith.

The Lehman Brothers case discussed on page 20 provides some insight into how courts can interpret fiduciary duties.

**Fiduciaries in Financial Services**

In financial services, a number of potential fiduciary relationships can arise, including:

• The trustee of a unit trust or pension plan towards its members
• The directors of a financial services entity, including the directors of a trustee company\(^2\)
• A stockbroker, insurance broker or other independent adviser
• Agents appointed to act on behalf of a principal, which can extend to investment managers (and in the US does so under the ERISA\(^3\)).

In some cases, it will not necessarily be clear who is a fiduciary. For example:

• With defined contribution pension providers that are not trustees, and where the role of parties such as insurance companies, asset managers and employer sponsors may be unclear. It may be that, in such cases, regulation is needed to clarify the position (such as requiring a trust as the foundation of a pension plan or imposing statutory duties on such providers that attempt to mirror fiduciary obligations), as otherwise it is left to case law

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\(^2\) Directors of a trustee entity are responsible to ensure that the trustee meets its fiduciary obligations and a failure to ensure this may result in a failure to fulfil the director’s fiduciary relationship towards the trustee company.

\(^3\) *Employee Retirement Income Security Act*, which requires that any person exercising a discretion over investment assets is a fiduciary.
Financial advisers, whose obligation to act in the best interests of their client has been entrenched in law in some jurisdictions.

There has been some international examination, for example, of where fiduciary duties might arise in the context of investments, and whether the duty is simply to maximize the investor’s/principal’s financial interests, or whether it also extends to corporate and social responsibility.

**The Psychology of Conflicts of Interest**

In understanding how to address the issue of conflicts, it is both useful and insightful to have a sense of the psychology behind them.

Researchers from Carnegie Mellon University have, over several years, conducted some very interesting research into the human elements of conflicts and some of our purported solutions to them.

So, what happens to us when there is a conflict of interest? In “Self Interest, Automaticity and the psychology of conflicts of interest,” the authors observe that:

*Self-interest is automatic, viscerally compelling, and often unconscious. Understanding one’s ethical and professional obligations to others, in contrast, often involves a more thoughtful process. The automatic nature of self-interest gives it a primal power to influence judgment and make it difficult for people to understand its influence on their judgment, let alone eradicate its influence.*

So, rather than being a deliberate and conscious “evil” act, acting in conflict with another’s interest can often be automatic and done without conscious awareness. Acting in someone’s best interests, or even ignoring our own self-interest, is something that requires deliberate work and thought.

In quoting another researcher, they note:

*Where [conscious] thought conflicts with emotions, the latter is designed by the neural circuitry in our brains to win.*

In other words, we are wired to actually act on a conflict of interest, and need to proactively stop ourselves from doing so. Further, the research also reveals that, when you or I are under cognitive load (or pressure), we are far less likely to favour the rational over the irrational, and thus will default to instincts over thoughtful consideration. So, under pressure, such as to meet deadlines or performance targets, we will find it even more difficult to identify and rationalize the conflict, and make the “right” decision about it.

If our conflicted selves, then, are both first on the scene to assess a situation, and also dominant in decision-making, and only afterwards can our thoughtful selves arrive to churn through the cognitive logic involved in applying our “higher selves,” by trying to address conflicts of interest we seem to be regulating against human nature. Add to this the challenge that a great many people don’t seem to understand or appreciate the fact that conflicts of interest exist, or that they may be influenced by them, and many others may not have the intellectual rigor needed to work through the challenge of identifying and resolving the conflict.

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What Type of Conflicts of Interest Can Arise in Financial Services?

Financial services and the structure of how those services are provided cause conflicts of interest to arise in a great many circumstances. In general terms, conflicts of interest can arise:

- Between a financial services firm and a client
- Between two or more clients of the same financial services firm
- Within the same financial services firm or corporate group, such as between different departments or functions.

Outlined below are a few of the most obvious conflicts of interest that can occur in various sectors of the financial services industry. It is fair to say that, where remuneration is skewed in a certain direction, the actions and decisions of those with conflicts of interest will tend to follow the money.

**Securities and Banking**

- **An investment bank** conducting both advisory activities and securities research. Invariably, the advisory work – such as advising in respect of corporate activities ranging from listings, mergers and acquisitions, and underwriting of securities offerings – is far more lucrative than the work of the investment bank’s investment analysts whereby they analyze securities and make investment recommendations to the bank’s clients. This creates a natural incentive for the bank to promote or make favourable recommendations for securities in order to remain in favour with actual or potential advisory clients.

- **Proprietary trading/dealing** by firms can lead to inappropriate advice or transactions against the client’s favour, such as front running (where a broker executes the firm’s own trades on a security before executing its client’s trades in the same security, often taking advantage of information about pending client transactions).

  - **Goldman Sachs**: One of the most public wrongdoings of this nature was the continued packaging and sale of RMBS and CDO securities to its clients while, at the same time, Goldman was betting big against RMBS and CDO securities by shorting the securities. In some cases, Goldman intentionally placed poor quality or loss-making securities into the RMBS and CDOs. Goldman never told its clients that it was taking these short positions, or of its true views on these securities, and in 2007 alone managed to make US$3.7 billion in profits from the decline in the mortgage market.

- In the case of a conglomerate with securities underwriting, broking, and retail banking and investment services, various scenarios can arise such as the underwriter selling securities to related entities or clients, such as bank clients or to retail investment vehicles such as pension funds and unit trusts.

- **Client orders** may be “matched” with other client dealings, and securities “crossed” between clients (that is, where a firm arranges for one client to buy the securities of another client). These transactions can favour one client over others.

- **Proxy advisory firms**, which provide assessments and recommendations to institutional investors regarding annual voting at shareholders’ meetings, are starting to offer consultancy services to the companies they assess to assist them to improve their corporate governance ratings, or to gain shareholder support for potentially controversial issues such as executive remuneration.

- Demutualizations of, and the entry of for-profit, securities exchanges has led to conflicts between the supervisory and public interest role of these exchanges, and their commercial interests. An exchange, particularly one competing with other emerging exchange platforms, may feel less inclined to challenge an issuer or broker-dealer that brings in substantial revenue.
Insurance

Insurance intermediaries can be particularly prone to conflicts. For background, a broker is an intermediary that acts on behalf of the purchaser of insurance, and the broker’s role is to advise their client on their insurance needs, and obtain the best price and terms possible for that insurance. They will usually act as the liaison between the insurer and the policyholder, and may assist with making claims and other administrative matters.

An insurance agent, by definition, acts on behalf of the insurer. Their acts are usually taken to be the acts of the insurer, who is generally liable for their conduct. It is possible, depending on local law, for an agent to represent more than one insurer (multi agents).

An insurance (claims or loss) adjuster’s role is to investigate a claim and determine the value of a claim. Adjusters that act for the insurer may aim to settle a claim as inexpensively as possible for the insurer. Adjusters may also be hired by the policyholder/claimant to assist in the preparation and submission of the claim, and it is these adjusters that need to ensure they do not operate under a conflict of interest.

Insurance brokers can often find themselves in conflicted situations, particularly where they are not operating independently but instead are remunerated in such a way as to potentially be influenced to not represent their client appropriately. One particular concern that often arises is broker remuneration, which is usually commission-based (as a percentage of the premium paid by the client). Without a straight “fee for service” model, commissions are an inherently conflicted way to remunerate intermediaries as the incentive exists to drive business towards products with higher remuneration products, or to “churn” business in order to generate new upfront commissions.

In some cases, some traditional life insurance products can create particular problems. For example, this applies to products with extremely high upfront commissions (which can exceed 100% of the premium) and very high penalties for withdrawal by the customer in the early years. These contracts may be single premium, or regular premium policies that lock policyholders into making contributions for 20 or more years. Under the terms of the contract, the policy will not have any surrender value at all for some time and may impose very large penalties for early withdrawal. In the writer’s view, such products are unconscionable, and the inherent conflict created by their appearing in any offering cannot be overcome by regulation or disclosure.

Conflicts also clearly arise where “vertical integration” opportunities to cause insurance companies to acquire brokers, leading to the product issuer having control over a purportedly independent intermediary.

In the case of insurance agents, who by definition act for the insurer, technical conflicts are less prevalent unless they are multi-agents, although practical concerns are not uncommon since clients will frequently have an ongoing relationship with the agent and place trust in them, and clients may not properly understand the agent’s natural bias toward the insurer.

For all insurance intermediaries, soft dollar (or non-financial) commissions, such as incentive trips, and marketing and administration support, are prevalent and in practice can have a major impact on recommendations.

Pensions

Pensions are often operated under a trust structure, but not necessarily always so. Historically, it is not uncommon for public offer pension funds to have arisen from life company operations, which can offer
accumulation funds to the public, or groups of employees, and many are influenced or organized by employers as part of their employment benefits.

Where pension providers are fiduciaries, there will always be a conflict between the commercial interests of the provider and its fiduciary obligations to its members. In addition, conflicts of interest can frequently arise:

- In the case of an employer-sponsored scheme. Although the interests of employers and employees should mostly align, there are cases where those interests can diverge. This includes where the fund is permitted to invest, or has invested, in employer shares, and in cases where there is a surplus or a contribution holiday and the parties need to ascertain who is entitled to these. Also, conflicts can arise where employers have excessive control over the choice of investments or insurer.
- Where the pension provider is part of a corporate group, often as a subsidiary or related company of a life insurer, asset manager/investments company, or bank. Numerous opportunities arise for conflicts, such as whether the investments of the pension fund will be directed to the in-house providers (including bank deposits or unit trusts for cash investments, the choice of insurance associated with the fund or annuities for the decumulation phase, and outsourcing to related companies. In such arrangements, it is not uncommon for various group entities to take a “clip” on fees.

**Corporate Groups**

The consolidation of financial services into integrated corporate groups has led to efficiencies in the sector, but also can significantly increase the potential for conflicts of interest. Where financial services providers are members of corporate groups, the usual “top-down” control of subsidiaries where the parent appoints directors and management, decides on corporate policies, and moves around capital to suit the group can often be inappropriate. In the case of financial services, the subsidiary should often continue to have a separate identity and its own controls in place.

Take, for example, a group that encompasses banking, investments, insurance and pensions:

- A bank may be lending banker or a financial adviser to an issuer of securities or other financial instruments that are the subject of services provided elsewhere in the group (such as broking or investment services). For example, an investment fund may acquire shares in an issuer, for whom the related bank has a significant lending exposure.
- It will be common for operations to be “outsourced” to a single entity in the group, which will perform all administrative, customer services and other functions for the group. This can create a merger of activities, and a loss of identity for institutions that can need to exercise a higher level of protection for their clients.
- Under such an arrangement, it will be very common for “back office” services to be consolidated for the group, including important “gatekeeper” functions such as risk, compliance, internal audit, and legal. This can potentially lead to conflicts of interest within those functions, particularly if they are not well resourced or do not have the authority or political or technical grunt to raise concerns about governance or process.
- Executives will often serve in a particular capacity across an entire corporate group. For example, the CEO or CFO of the parent will frequently hold the same office for the subsidiaries, such as for a life insurance company, a pension trustee, and the back office service provider. This can place such executive in conflicted situations if they are making decisions for all entities in a group, particularly where some of those entities are fiduciaries such as trustee entities. For example, they
may receive confidential information about one financial entity (including liquidity or asset value issues) which impacts adversely on a related financial entity that invests in the first entity.

- It is common for even so-called “independent” advisers to be employed by an entity in a corporate group. Often, they will be more handsomely remunerated by placing larger volumes of client business with group companies.
- Pressure can be placed on customers to acquire products from affiliated companies – such as borrowers from a bank being pressured to acquire related insurance products issued from elsewhere in the group, or depositors being pressured to invest in higher-commission (and riskier) investment products.
- Investment funds or advisers may routinely offer to clients or prefer to offer related company investment vehicles, bank deposits or insurance options, including by placing client money into such funds or accounts.
- Transactions between related parties in a group can be subject to conflicts, particularly when:
  - There is a shifting of resources (such as profits or capital) between entities, a transfer of assets from one entity to another (including a trust controlled by an entity), or any entity in the group is capable of being directed to undertake a certain transaction by the parent or another upstream entity; or
  - Any of the entities involved is a fiduciary such as a trustee of a pension plan or of a unit trust.

Professional Services

The most prevalent examples in the past decade or so have related to auditors, who are meant to act as an essential gatekeeper for investors and other third parties in ensuring financial statements of an enterprise are accurately presented. However, if the auditing firm is also able to conduct consulting work for the audited entity, this raises two types of potential conflicts:

- The audit firm may have to assess or audit work that the firm itself has done as part of a consulting engagement, such as recommendations they have given, or structures that they have endorsed
- The consulting work may bring in higher levels of or more profitable revenue for the audit firm than its auditing business, leading to a natural conflict if the firm wishes to gain more non-audit engagements to increase the workflow from the same client.

These kind of abuses were most startling in the case of Enron, when Arthur Andersen failed to perform its audit role with sufficient vigilance, including by failing to inform Enron’s board of the off-balance sheet partnerships, and allowing Enron to continue to push the creative accounting envelope, that ultimately destroyed Enron. Arthur Andersen was more than just an auditor – it was conducting lucrative non-audit consulting work. Enron was paying Andersens US$27 million annually for non-audit services, while the audit costs were US$25 million.6 The close ties between the two organisations became obvious in daily life at Enron:

*Andersen auditors and consultants were given permanent office space at Enron headquarters here and dressed business-casual like their Enron colleagues. They shared in office birthdays, frequented lunchtime parties in a nearby park and weekend fundraisers for charities. They even went on Enron employees' ski trips to Beaver Creek, Colo. “People just thought they were Enron*

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employees,” says Kevin Jolly, a former Enron employee who worked in the accounting department. “They walked and talked the same way.”

The Enron failures ultimately led to the collapse of Arthur Andersen, who – despite the Enron team being only a small portion of the firm’s partners and staff - could not withstand the reputational failures arising from the events, and in particular their revelations that the firm had destroyed documents once the heat was on. Although the firm’s conviction for obstruction of justice was overturned on a technicality, it was too late for the 85,000 staff; the firm handed in its CPA licence in 2002 and its practices around the world were mainly subsumed by its competitors.

Many jurisdictions have now imposed requirements that prohibit audit firms from conducting work outside the audit engagement, and requiring auditors to be independent.

Credit Rating Agencies

For a long time, credit rating agencies have operated under an inherently conflicted business model, despite their being an institutional “gatekeeper” that investors relied upon to scrutinize potential investments. On the one hand, they earned fees from issuers who sought their high ratings, and on the other they sold their reports to users to provide what should have been fair and objective assessments of those issuers and their financial instruments. In the lead-up to the Financial Crisis, ratings agencies were unwilling to issue anything other than AAA ratings for Collateralised Debt Obligations and Collateralised Loan Obligations for fear that the Wall Street firms would end up in the competition’s arms. Internally, it was not uncommon for staff responsible for ratings assessments to be involved in fee negotiations and deal structuring. Conflicts were also more prevalent in structured offerings, where the fee regime encouraged volume over ratings quality. In some cases, credit rating agencies also began to branch into consulting to assist issuers to structure their securities in order to obtain the highest ratings.

Add to this the fact that the gaining and maintenance of credit ratings has become part of the fabric of many commercial transactions and regulatory requirements, with both issuers and holders of securities being motivated to desire that ratings for those instruments are not downgraded.

As readers would be aware, the role of credit rating agencies has come under tougher scrutiny since the Financial Crisis, and stricter rules have been imposed on such businesses.

How Can Conflicts of Interest Be Dealt With?

The alternatives for dealing with conflicts of interest are, essentially:

- **Manage** the conflict by establishing protocols or processes to mitigate the potential effects of the conflict such as:
  - Separation of duties
  - Information barriers

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7 Ibid.
9 See note 3.
10 For example, in addition to reforms in the US (the *CRA Reform Act*), the European Union has imposed new rules (updates to the *EU Regulation on Credit Agencies 1060/2009*) that commenced in June 2013. The new rules reduce reliance on credit ratings by forcing institutions to conduct tougher internal credit assessments, making agencies accountable for their ratings, and requiring more transparency in the ratings of sovereign states.
- Conflicts review committees
- Obtaining advice from an independent third party
- Adjusting remuneration structures for key personnel to delink their interests from the conflicted issues or behaviours.

- **Disclose** the conflict, preferably in a manner that is easy to understand, and before any decision is made by the principal
- **Avoid** the conflict altogether, if neither of the above solutions is sufficient.

### How Do These Options Stack Up?

Of the options, there is little doubt that avoiding conflicts of interest is the superior solution, provided that it can be done without disproportionately increasing cost or causing other harm, such as closing off access to advice. Fiduciaries in particular must, in theory, avoid conflicts rather than adopting other alternatives, although fully informed disclosure (which encompasses a very onerous compliance requirement) is also possible. However, avoidance of conflicts can have its downsides, and in practice would reverse some of the benefits gained from scale efficiencies, such as in financial services conglomerates.

Management of the conflict will only be as good as its execution, and the appropriateness of the solution identified.

Disclosure of conflicts, as a solution, is better in theory than in practice. In theory it attempts to close some of the gap in information between two parties and can allow the potentially vulnerable party to seek alternative advice, or to discount the conflicted advice. But in reality it is a weaker solution since it still allows the conflict/bias to endure, whereas removal of these would be far more difficult, and only the most sophisticated (and likely least vulnerable) clients would be in a position to effectively compensate for the bias.

The interesting work by Carnegie Mellon University referred to above has extended into the effectiveness of disclosure to address conflicts of interest. They and others have observed the fairly perverse effects of disclosure of conflicts of interest:

- **For the client:**
  - Clients can tend to place *more* trust in the conflicted adviser, rather than less. They feel that the disclosure of the conflict makes the discloser seem more “honest”, and more trust is placed in the conflicted party
  - If clients do discount advice from biased advisers, they do not discount it as much as they should\(^{11}\)
  - Although disclosure can decrease the client’s trust in the advice, it can also increase pressure to comply with that advice if clients feel obliged to satisfy their adviser’s personal interests (such as arising from a personal relationship). Hence, disclosure can burden those it is ostensibly intended to protect\(^{12}\)
  - Disclosure documents can be lengthy and become “boilerplate,” leading to them not being read or understood at all.

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\(^{12}\) Sah, S., Loewenstein, G., and Cain, D.M., “The Burden of Disclosure: Increased Compliance with Distrusted Advice,” *Journal of Personality and Social Psychology*. Solutions identified include allowing the client to make their decision in private, or allowing a cooling off period.
• For the adviser:
  o Disclosure can increase the bias in advice as the adviser feels morally licensed and strategically encouraged to exaggerate the bias, and correspondingly does not feel the need to balance their advice.\(^\text{13}\)
  o Intermediaries can underestimate the risk of a conflict arising, leading to insufficient disclosure.\(^\text{14}\)

So, why use disclosure at all as a tool to address conflicts of interest? Perhaps because it’s easy and everybody gets to feel like they are doing something about the conflict; plus being “transparent” makes everyone feel better.

**What About Other Regulatory Approaches to Minimize Abuse of Conflicts?**

There is little doubt that reputation is crucial to financial services firms, perhaps even more so than many other types of commercial enterprises due to the importance of trust in financial services. Accordingly, it is generally in firms’ commercial interests to effectively manage conflicts and comply with their regulatory obligations, although this does not always provide the necessary outcomes if the firm culture, resources or the rewards for non-compliance are not properly balanced.

Noting that deterrence is particularly ineffective as a solution to conflicts of interest, due to the immediate attraction of acting on the conflict versus the less tangible risk of punishment, the particular solutions that the research has identified include:

• Proscribing certain conduct as illegal. However, the threat of punishment can simply have the effect of attaching a “price” to the poor conduct so needs to be severe and accompanied by implicit moral judgment
• Rewards (even just symbolic ones) can be useful to highlight positive behavior and establish the standards for professionalism
• The internalization of the desired values (i.e., acting in the client’s interest) is essential, as then proper and ethical behavior is far more likely to have their root in the more powerful automatic responses; accordingly, considering ways to attach “shame” to poor conduct could be useful
• Weaving ethics into professional training in the financial services sector.

Supervisors play an important role in building the framework needed to take advantage of these social motivators, including:

• Ensuring that the market has both the information (including education for both the industry and consumers, such as by information releases about hot topics and monitoring international trends and emerging issues) and also incentives to control conflicts
• The encouragement of Codes of Conduct, which will work best when created as a collaborative effort between industry and regulators and is then actively enforced
• Regular and proactive supervisory oversight, including risk-based assessments and thematic reviews
• Taking on some of the psychology above, which notes that regular practice can shift actions from cognitive into instinctive (such as learning a new skill such as dancing the salsa, which requires

\(^{13}\) Ibid.
deliberate practice but, over time, can become far more instinctive).\textsuperscript{15} is it possible that mandating that industry “practice” conflicts identification and resolution could improve regulatory outcomes?

**Regulatory Approaches to Conflicts of Interest\textsuperscript{16}**

**International Organization of Securities Commissions (IOSCO)**

Approaches to address the issue of conflicts of interest are regular features in much of IOSCO’s work. The most recent of these include:

*Guidance for the Effective Resolution of Conflicts of Interest facing Market Intermediaries*, Final Report, October 2010. This guidance was developed specifically for emerging markets regulators, and arises from a survey of numerous developing market securities supervisors. The report notes that the regulatory framework should create a balance between [strong/harsh regulation and the benefits of economies of scope] and “most importantly aim to affect the behavior of the management of an intermediary through emphasizing the importance of adopting strict internal control measures to avoid conflicts of interest from arising.” The guidance identifies remedies and guidelines for emerging markets addressing conflicts of interest for intermediaries.


*Principles for Financial Benchmarks* issued on 17 July 2013 and endorsed by the G20 in response to the LIBOR scandal in 2012 where widespread manipulation of interest rate benchmarks were found. These Principles establish governance standards to address conflicts of interest.

*Report on Private Equity Conflicts* (FR 11/10), issued in November 2010, which examines the type of conflicts that can arise in private equity firms or funds, and sets out principles for the management of conflicts of interest.

*Credt Rating Agencies* (FR 12/12), 21 December 2012.

*Transparency of Firms that Audit Public Companies* – Consultation Report, 28 October 2010.


**International Association of Insurance Supervisors (IAIS)**

A number of the IAIS Insurance Core Principles address issues arising from conflicts of interest, both in specific terms, and also as part of the broader principles:

- ICP 8 on risk management and internal controls encompasses the need to manage conflicts of interest effectively.
- ICP 19 on Conduct of Business, focuses on appropriate supervision of ensuring fairness to the client.
- ICP 7.6.6 recommends the mitigation of potential conflicts for staff in control functions, such as ensuring they do not report directly to the business unit they are overseeing, or have substantial amounts of their remuneration tied to the profitability of the business unit. Appointed actuaries and auditors also should be subject to conflicts management; for example, the appointed actuary and auditor should not be in the same firm.

\textsuperscript{15} See page 6 of Cain, Lowenstein, and Moore’s article (point 12 above).

\textsuperscript{16} This section is not a comprehensive list of conflicts regulatory issues in the named countries or the peak bodies; instead, it provides an idea of how conflicts are addressed, and in some cases, some particular local examples.
ICP 15.4.5 recommends that insurers must be required to manage conflicts of interest, such as between the insurer’s corporate objectives, and the objectives of the insurance policies issued by them, and ensure that assets are invested prudently and in accordance with expected liquidity needs.

ICP 16.16.17 recommends that conflicts management should be part of an insurance group’s Enterprise Risk Management Framework; and

ICP 18.5.8 recommends that conflicts with respect to intermediaries be managed, such as the intermediary’s relationship with the corporate group via an insurer owning a broker, or a broker owning shares in the insurer.

**International Organisation of Pension Supervisors (IOPS)**

At this stage, the work of the IOPS is not as comprehensive as other peak bodies for financial supervisors. The most relevant work conducted is the OECD/IOPS Good Practices for Pension Funds’ Risk Management Systems issued in January 2011. The Good Practices anticipate that conflicts of interest are dealt with in the pension provider’s governance risk management, and that they should effect a conflicts of interest policy.

**Australia**

Financial services providers, a category that includes a broad range of businesses including banks, securities intermediaries, insurers, insurance intermediaries, and pension providers, must hold an Australian Financial Services Licence. Holders of financial services licences must meet a number of general licensing obligations, including:

- To act efficiently, honestly and fairly
- 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.

Conflicts of interest are also the subject of the Australian Securities and Investment Commission (ASIC) Regulatory Guide 181 “Licensing: Managing Conflicts of Interest”, which provides guidance on ASIC’s view of conflicts.

Under the recent Future of Financial Advice (FOFA) reforms the following changes were implemented at 1 July 2013:

- Conflicted remuneration for financial advisers has been banned for new products sold to retail clients, including commissions and volume-based remuneration
- Financial advisers are required to act in the best interests of their clients, and prefer the client’s interests to their own, with prescribed steps that can be taken by advisers to be in a “safe harbour”
- Advisers need to have their instructions confirmed at least every two years in order to continue to charge their client fees.

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17 Although the IOPS Tool-Kit for risk-based supervision is a useful tool, even for non-pension supervisors – see [http://www.iopstoolkit.org/index.html](http://www.iopstoolkit.org/index.html).

18 Section 912A(1) Corporations Act.

However, the new Government has indicated that it intends to roll back a number of the reforms, including the mandatory requirement that advisers act in the best interests of their clients.  

**United Kingdom**

Principal 10 of the Financial Conduct Authority (FCA) Principles for Business requires that firms must manage conflicts of interest fairly, both between the firm and its customers, and also between customers. The Senior Management Arrangements, Systems and Controls (SYSC) of the FCA Handbook requires that firms manage conflicts of interest so they do not damage the client’s interest, and sets out specific rules for their management (SYSC 10). There are also specific rules relating to inducements, which (in general terms) prevent payments from product issuers that are not in the interests of the client and that are not disclosed.  

**Review of Asset Management Firms**

From June 2011 to February 2012, the Financial Services Authority (the predecessor to the FCA) conducted thematic reviews of asset management firms to determine how well they had complied with the requirements to manage conflicts of interest. The FSA reported its findings in November 2013, issuing the paper “Conflicts of Interest between Asset Managers and their clients: Identifying and Mitigating the Risks.” The paper is worth a read, and concludes:

> In most cases senior management failed to show us they understood and communicated this sense of duty to customers or even that they had reviewed or updated their arrangements for conflicts management since 2007. In these firms, employees too often lacked awareness of situations where short-term business goals conflicted with the long-term interests of customers.

The FSA decided that the failures to manage conflicts of interest were so serious that a report needed to be issued, and a formalized follow-up regime implemented, under which the boards of asset managers had to consider conflicts issues and the CEO was required to submit an attestation to the FSA about the policy’s effectiveness and compliance. These were then followed up with a second round of visits, presumably by the Financial Conduct Authority, which assumed the FSA’s responsibility for conduct supervision from 1 April 2013.

The general findings of the review included:

- There was a strong correlation between the firm’s culture and the management of conflicts of interest
- Conflicts management frameworks were the most effective where their design and monitoring were a collaboration between the business and compliance/legal units. Management by the compliance function alone meant that the firm was unable to demonstrate how challenges could be made to senior staff within the business unit
- Compliance seemed weaker in subsidiaries of overseas firms, particularly where local boards (of the authorized entity) did not effectively to ensure compliance
- Considerably less care was taken when spending customer money on broker research and execution services, as compared to how the firm spent its own money on such services. This resulted in new rules being imposed in relation to “dealing commissions,” which is the pass-through of the asset manager’s costs to fund clients

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21 Conduct of Business Sourcebook (COBS) 2.3.
22 You’ll find it at: [http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf](http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf)
• Few firms had given any thought to how gifts or entertainment could create a conflict of interest
• There were frequent problems arising from the allocation of trades, and firms could often not prove that cross-trading between customers was always in the best interests of both customers.

Retail Distribution Review (RDR)
In 2006, the FSA launched its Retail Distribution Review, the results of which took effect from 31 December 2012. The RDR reforms were implemented in the U.K. to the distribution of retail products such as life insurance, personal pension products and investments in unit trusts. A number of reforms were implemented to increase the professionalism of the independent financial advice industry, and the changes relevant to conflicts of interest included:

• Requiring that advisers disclose whether they are independent advisers, or “restricted” advisers, allowed only to provide basic advice or non-advice services such as execution only
• Prohibiting product manufacturers from paying upfront or trail commissions on new products
• Prohibiting the charging of fees by advisers unless they are for an ongoing service.

In September 2013, following a thematic review on the implementation of the RDR changes, the FCA issued a Guidance Consultation paper “Supervising retail investment advice: inducements and conflicts of interest.” The review considered whether other payments or benefits apart from commissions were being implemented to secure product distribution.

The FCA found that over half of the firms reviewed had arrangements that could breach Principle 8, the inducements rules, and undermine the intentions of the RDR reforms.

United States
The United States has a long and rich history of being worried about conflicts of interest. Conflicts were a major impetus for the passage of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Glass-Steagall Banking Act of 1933. The Investment Advisers Act of 1940, which regulated the relationship between advisers and their clients, was passed in response to widespread concerns about conflicts of interest and the need to protect investors from “misrepresentations of unscrupulous tipsters and touts.”

Moving into the future another 70 years, the Financial Crisis of 2008-10 may well have set new high watermarks for the influence of conflicts of interest and flagrant disregard for client interests. Numerous examples of misconduct, amounting to abuse of conflicts of interest by investment banks and credit rating agencies in particular, became public knowledge, and were considered in detail in official reports such as the Financial Crisis Inquiry Report issued in January 2011 (at page xix):

We conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis. There was a view that instincts for self-preservation inside major financial firms would shield them from fatal risk-taking without the need for a steady regulatory hand, which, the firms argued, would stifle innovation. Too many of these institutions acted recklessly, taking on too

much risk, with too little capital, and with too much dependence on short-term funding. In many respects, this reflected a fundamental change in these institutions, particularly the large investment banks and bank holding companies, which focused their activities increasingly on risky trading activities that produced hefty profits. They took on enormous exposures in acquiring and supporting subprime lenders and creating, packaging, repackaging, and selling trillions of dollars in mortgage-related securities, including synthetic financial products. Like Icarus, they never feared flying ever closer to the sun.

...Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited. This was the case up and down the line—from the corporate boardroom to the mortgage broker on the street.

Following the Financial Crisis, the U.S. Government passed comprehensive and widespread reforms to the supervisory and regulatory framework for financial services, contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). One of the purposes of the new law was to try and restore confidence in the system by increasing protections for investors.

Some of the specific responses in Dodd-Frank to conflicts of interest include:

- The requirement that a uniform fiduciary standard be in the “best interests” of the client “without regard” to the financial interests of the broker or the firm providing the advice
- Requiring that the SEC:
  - Facilitate simple and clear disclosures of conflicts of interest
  - Prepare a study on conflicts of interest involving analysts
- Specific governance requirements were introduced for credit rating agencies, including separation of duties for compliance personnel
- Section 621 prohibits an underwriter, placement agent, initial purchaser, sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security from engaging in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity for a period of one year after the date of the first closing of the sale of the asset-backed security.

Perhaps the most far-reaching provisions is section 619, otherwise known as the Volcker Rule, which attempts to minimize conflicts between banks and their clients by the separation of business practices engaged in by financial institutions. In general, the Volcker Rule (which is extremely complex, and subject to exceptions) prohibits banking entities from:

- Engaging in short-term proprietary trading of securities, derivatives, commodity futures and options on these instruments for their own account
- Owning, sponsoring, or having certain relationships with hedge funds or private equity funds.

The Volcker rule effects the separation of investment banking, private equity and proprietary trading (hedge fund) sections of financial institutions from their consumer lending arms. Banks cannot act in both an advisory and a creditor role with clients, such as with private equity firms, at the same time.
It is not surprising that the SEC, as part of its risk-based approach to supervision, has prioritized conflicts of interest specifically in 2012 and its priorities for 2014 reflect issues that will encompass conflicts management and governance.

**European Union**

In 2007, the European Union implemented MiFID, the Markets in Financial Instruments Directive, which became the cornerstone of financial markets regulation the E.U., and while it was intended to provide increased investor protection, investors did not benefit as much as planned. Since that time, all advising and dealing firms based in E.U. member states have been subject to a statutory requirement to “act honestly, fairly and professionally in accordance with the best interests of its clients.”

Following the Financial Crisis, in October 2011, the E.U. released its further round of reforms to MiFID (known as MiFID II), which was originally intended to introduce a broad range of additional reforms including:

- A ban on inducements such as commissions being paid to certain firms such as asset managers and independent financial advisers
- The requirement that advice meet certain criteria before it can be called “independent”
- Allows some investors previously regarded as “professional,” such as local authorities, to be treated as “retail” clients
- Limits a regime for “execution only” services to non-complex products.

There has, however, been considerable disagreement about certain of the MiFID II provisions, including the extent of the proposed ban on inducements, and they remain under negotiation between the E.U.’s three peak regulators, the European Commission, the European Parliament, and the Council of the European Union. After being watered down to apply only to independent advisers following lobbying from German banks in mid-2013, it appeared in November 2013 that it was still possible that the stricter rules could still be adopted as part of the broader MiFID II negotiations. However, local regulators will, in any event, be able to specify their own approach to inducements, and both the U.K. and Netherlands have implemented such bans.

To confuse matters further, at the same time the E.U. is implementing new common marketing and disclosure rules for packaged retail investment products (or PRIPS), whatever their form. For insurance, revisions to the Insurance Mediation Directive (IMD2) is also being finalized and is intended to align the disclosure requirements for insurance products with an investment component with those of other retail investment products. This would assist in addressing the perceived mis-selling problem for insurance investment products by reducing the risk of regulatory arbitrage, and also levelling the playing field amongst the different types of insurance intermediaries and sellers of insurance. Of particular relevance to conflicts of interest are the proposed requirements for intermediaries to make their status clear (i.e.,

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25 Carlo V. di Florio, Director, Office of Compliance Inspections and Examinations, SEC (October 22, 2012) in a speech to the National Society of Compliance Professionals.
28 Published on 17 December 2013 in the Financial Markets Amendment Decree 2014.
29 Which includes investment funds, insurance-based investment products, retail structured securities and structured term deposits.
30 For EU27, the IMD has estimated that the potential cost to consumers of mis-selling insurance products could be €1.7 trillion.
whether independent or tied to an insurer), and the nature and structure of their remuneration. For insurance, some states such as Finland and Denmark, have already banned intermediaries receiving commission from insurers.

Canada

On 25 October 2012, the Canadian Securities Administrators (CSA) released a consultation paper\(^{31}\) in which the issue of mandating fiduciary duties for financial advisers was considered, particularly in light of international developments. In their 17 December 2013 summary of the subsequent consultation work,\(^{32}\) CSA identified four key themes that had emerged:

- There was significant disagreement about:
  - whether the current regulatory framework for advisers adequately protects investors
  - what regulatory response is required
- A best interest standard must be clear
- The potential negative impact on investors and capital markets must be carefully assessed
- The regulators have ascertained that more work is needed, and undertook to provide a further update.

When Should the Supervisor’s Alarm Bells Ring?

- Large, complex organisations will most likely have the greatest potential conflicts due to the multiple lines of business. However, IOSCO has observed that these institutions may nonetheless have better processes.\(^{33}\)
- …But smaller organisations are less likely to have the resources and experience to identify and manage conflicts of interest.
- Poor corporate culture – dominant or “wunderkind” leaders, the dominance of sales and performance, and remuneration geared towards short-term profitability can all be red flags.
- If the psychology is right, organisations and individuals under additional pressure, including financial pressure, or that arising from a lack of resourcing.
- Lack of understanding about conflicts and how to manage them – does the Board, CEO and the layer of commercial management under the CEO know what you are talking about when you raise conflicts of interest? Can you have a meaningful and informed discussion on the topic with them? Or do you get a blank look, denial that conflicts exist or perhaps offended responses?
- Poor risk management systems and controls.
- Lack of collaboration between the business units and the control functions like risk, compliance and legal, or insufficient resourcing or seniority of these areas.
- Control functions that report into line managers – or even the CFO, and which do not have assured independence within the organization.
- The Board does not receive sufficient or honest reporting about compliance or risk issues, and does not specifically consider matters related to conflicts of interest.

\(^{31}\) Consultation Paper 33-403, “The standard of conduct for advisers and dealers: exploring the appropriateness of introducing a statutory best interest duty when advice is provided to retail clients”


\(^{33}\) “IOSCO’s “Guidance for Efficient Regulation of Conflicts of Interest facing Market Intermediaries”, Final Report, October 2010, p. 16.
• Fast profit growth/rapid expansion; in such a situation, it can be difficult to maintain compliance and risk frameworks in a consistent manner across the organization, and fast acquisitions can often cover up problems with capital or profitability.

Some Cases

Below are some cases that illustrate conflicts of interest. However, it’s certainly arguable that many, if not most, breaches of financial services conduct requirements, or breaches of any moral code, arise from conflicts of interest since a person acting to their own benefit and against the benefit of others, and thus against the accepted norms or requirements, is inherently about the preference of self-interest over any others.

Martin Currie Investment Management/Martin Currie Inc

A China-focused hedge fund affiliated with Martin Currie, an investment manager, had made a series of acquisitions of bonds issued by an unlisted Chinese company, which breached the firm’s own rules regarding single exposures after they were incorrectly classified as cash in the firm’s systems.

During the financial crisis, Chinese company became starved of capital and was unable to meet its commitments to bondholders. The hedge fund suffered severe liquidity problems due to a run on redemptions, but was short on the cash it needed due to its exposure to the Chinese company. Martin Currie arranged for a client, a US publicly-traded fund called The China Fund Inc, to enter into a Bond transaction with a subsidiary of the Chinese company that led to the hedge fund’s bonds being redeemed and had the effect of both reducing the hedge fund’s exposure and restoring the hedge fund’s liquidity, but which resulted in losses of US$11.5 million (or 50% of the face value) to the China Fund and its shareholders.

Although Martin Currie took the transaction to the board of directors of The China Fund, they failed to disclose the conflict or directly consider whether the transaction was in that client’s interest. Following The China Fund’s acquisition, Martin Currie also failed to disclose information to its client that would allow it to fairly value the bonds.

“The misconduct in this case strikes at the heart of the fiduciary relationship between an investment adviser and its client,” said Robert Khuzami, SEC enforcement director, in the agency’s statement. “Advisers must treat each client with undivided and disinterested loyalty, and must make full and fair disclosure of all material conflicts of interest.”

In May 2012, the FSA in the U.K. and the SEC in the U.S. collectively fined the Scottish funds management group US$14 million to settle the cases brought against it.

Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in Liq) (Grange)34

Background

During 2003-06, Grange Investments (acquired by Lehman Brothers in 2007) provided advice to various local governments/Councils in respect of the investment of their excess funds. The Councils were relatively unsophisticated, risk-averse investors, who wanted to ensure their funds earned the best returns.

34 [2012] FCA 1028.
they could consistent with a conservative investment policy. They had traditionally invested their funds in bank bills, term deposits and bank-issued floating rate notes.

In 2000, the rules concerning the permissible investments for local governments changed so that they were permitted to invest in any type of instrument provided that it was rated A1 or above by ratings agencies.

**What is an SCDO?**

A SCDO is a derivative product put together by a bank. The products are synthetic because they are not actually made up of loans or other assets. Instead, the arranging bank identifies a portfolio of investment grade securities issued by corporations around the world (the reference portfolio). These are used to determine whether or not the SCDO suffers loss or not. The arranging bank may not have any exposure to these institutions; instead they are used like a “test group” – a portfolio that may or may not default on their debts. The SCDO itself defines what an event of default is, which may be a ratings downgrade or another event (credit events) affecting the reference entities.

The arranger then selects a range of credit events that the investors are asked to bet will not occur. If, for example, the SCDO provides that a tranche of 6-7% of a total reference portfolio of 150 entities will not suffer credit events, then 10 (or 6.67%) of them will have to suffer a credit event before the tranche is affected. If the next credit event occurs, then the issuer of the SCDO has to pay a percentage or all of the investor’s capital to the swap counterparty (often the arranging bank). At that point, the capital is lost and no further interest is paid.

In this case, the secondary market for the SCDOs and its liquidity were, essentially, an illusion. Grange took the instruments from its clients and either sold them to someone else, or bought them back itself. In stable economic conditions, and while Grange had funds, the instruments could be sold quickly at or above face value.

**How Grange Made Money on the SCDOs**

Grange made money from the SCDOs in the following ways:

- Grange would purchase a new SCDO issue below its face value, and then on-sold it to clients at face value. This generated profits between $1-2 million for each new issue
- Grange also set the purchase and sale prices in the secondary market, as well as its profit margins in dealing with its clients
- Grange borrowed from its clients using repurchase agreements (repos) at less than the bank interest rate, which even senior staff at Grange believed was inappropriate.

**Grange’s Relationship with the Councils**

Grange marketed itself to local Councils as a financial adviser that understood the investment requirements of local government.

The Councils had one of two types of relationship with Grange, being:

- Some Councils acquired investments from Grange, so Grange was acting as a seller
- Others appointed Grange as their investment advisor, which gave Grange discretion to invest their money within certain fixed parameters. This included that securities had to be traded in an active secondary market, liquid, and prohibited investments in derivatives.
Under these arrangements, the Councils were advised to acquire, or Grange acquired on their behalf under investment management arrangements, synthetic collateralised debt obligations and other complex products (referred to as SCDOs). SCDOs had interest rates slightly above the traditional investments of these Councils, but had high credit ratings between AAA and AA+.

Grange told the Councils that the SCDOs were:

- A form of floating rate notes and, if held to maturity, would return the capital.
- Comparable to the investments to AAA-rated Australian Government debt and the AA-rated banks.
- Suitable for conservative investment
- Prudent, capital-protective products
- As liquid as the bank floating rate notes that the Councils were used to, and could easily be redeemed for cash and were easily tradable on an established secondary market.

Grange did not tell its clients that the secondary market was not assured, or (except in fine print once in 2007) that it was the provider of this secondary market.

The Legal Action

The SCDOs began to suffer credit events, many suffered losses, and others were wiped out altogether. Grange, short on cash, was unable to keep up the secondary “market” for the securities, and so the securities became illiquid.

Various Councils commenced a class action against Lehman Brothers, seeking damages. Their claims included that Grange was negligent, had breached contractual requirements, and acted in a manner that was “misleading and deceptive” under the Australian Securities and Investments Commission Act.

The Councils also claimed that, in each situation in which it acted for them, Grange was an investment adviser that owed them fiduciary duties.

The Judgment

The Court found for the Councils on all of the above claims, and made orders for compensation (which is pending the liquidation).

On the finding that there was a fiduciary duty both in making ad hoc acquisitions of SCDOs and also in acting as investment manager, where Grange had undertaken to act in the Councils’ interests when exercising investment powers and discretions. The history of their dealings, the lack of sophistication of the Council staff, their conservative risk tolerance, and the comparative expertise of Grange were all relevant to the Court’s finding that Grange was a fiduciary.

Grange was found to have breached its fiduciary duties in three key respects:

- In its receipt of substantial undisclosed fees in connection with the SCDO transactions;
- Acting in its own interests by earning large profits from every sale and by controlling the secondary market; and
- Entering into repurchase agreements with the Councils under which it effectively borrowed from them at below market rates.
The Court noted that Grange knew that the trust its uninformed clients had placed in it was being used to Grange’s advantage and that, whilst Grange informed its clients of its interest in the transaction, the disclosure was not specific enough to allow for fully informed disclosure.

**Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd**

**Background**

Citigroup in Australia carries on various businesses, including investment banking and proprietary trading in securities.

On 8 August 2005, Citi was retained by Toll Holdings Limited to provide financial advisory and investment banking services to it in relation to Toll’s proposed takeover of another listed company, Patrick Corporation. The transaction was large (over AU$4.5 billion) and both Citi and Toll were sophisticated parties. Citi’s fees for successful completion of the takeover were likely to be between $10-18 million.

Citi’s equities (proprietary trading) division was part of the same business within Citi as investment banking, but was separated by information barriers. Staff in the investment bank were on the “private” side, as they regularly came into possession of confidential price sensitive information about securities. The information barriers were to ensure that the equities division did not come into possession of price-sensitive information from the private side.

On Friday 19 August, a trader in Citi’s equities division acquired a substantial number of shares in Patrick. The trader was responding to movements in Patrick’s share price and rumours in the market Patrick was about to be the subject of a takeover, and there was no evidence that the trader had inside information. By mid-afternoon on that day, the trader held a large amount of Patrick shares, which had risen in value.

At 3.30pm, the trader’s boss took him out of the office. Cigarette in hand, he instructed the trader to stop buying Patrick shares. Returning to his desk, the trader sold down some of his position. During that afternoon and the evening of that day, Citi’s senior management and compliance team became aware of Citi’s substantial holding in Patrick shares.

Toll’s bid was announced on the following business day, Monday 22 August 2005.

**ASIC’s Allegations against Citigroup**

ASIC make two allegations against Citi:

- **The conflicts claim**: Citi had breached certain provisions of financial services laws by breaching its fiduciary duty towards Toll to avoid conflicts of interest and duty
- **The insider trading claim**: Citi (rather than the trader) had engaged in insider trading, in respect of:
  - the sale of shares that occurred after the “cigarette on the pavement” conversation; and
  - all of Citi’s trading on that day (based on ASIC’s claim that Citi could not rely on the defence of having information barriers in place).

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The financial services laws involved were:

- Citi’s obligation to have adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee\(^\text{36}\)
- Misleading and deceptive conduct in relation to financial services\(^\text{37}\)
- Unconscionable conduct in relation to financial services\(^\text{38}\)

This summary is focused on the conflicts of interest claims. ASIC lost the insider trading case because (i) the trader was not an officer of Citi, so even if he had information after the cigarette on the pavement discussion, it could not be attributed to Citi; and (ii) by having arrangements that could reasonably be expected to ensure that information would not pass from the private to the public side, Citi had met the requirements for the defence.

The Conflicts Claim

Importantly, ASIC was alleging that by breaching its fiduciary duties towards Toll, Citi was failing to comply with its obligation to have adequate arrangements for the management of conflicts of interest.

Since ASIC chose to rely on Citi’s alleged breach of its fiduciary duties to prove a breach of the financial services laws, the core issue in this part of the case was: did Citi owe fiduciary duties to Toll?\(^\text{39}\)

The three elements of proving a breach of fiduciary duty, and the Court’s findings, were as follows:

<table>
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<tr>
<th>Issue</th>
<th>Finding</th>
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<tbody>
<tr>
<td>1 <strong>Fiduciary point</strong></td>
<td>No. The contract explicitly stated that Citi was not a fiduciary. Fiduciary duties, apart from the established categories of fiduciary relationships, arise from the contract between the parties and, if there is no mistake or other contractual flaw, then the contract prevails.</td>
</tr>
<tr>
<td>Was the relationship between Citi and Toll a Fiduciary one?</td>
<td>ASIC argued that Citi needed Toll’s informed consent to exclude the fiduciary duty, but the judge disagreed as this argument assumed some kind of pre-contractual fiduciary relationship. Interestingly, the judge held that, but for the contractual provision, Citi would most likely have acted in a fiduciary capacity.</td>
</tr>
<tr>
<td>2 <strong>Conflicts point</strong></td>
<td>Although the judge didn’t need to, he gave reasoning for why he felt that, even if there had been a fiduciary relationship, Citi had not breached its duties:</td>
</tr>
<tr>
<td>If the relationship was fiduciary, Citi acted in conflict of interest by:</td>
<td></td>
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</tbody>
</table>

\(^{36}\) Section 912A(1)(aa) Corporations Act.
\(^{37}\) Section 1041A Corporations Act and section 12DA Australian Securities and Investments Commission Act.
\(^{38}\) Section 12CA Australian Securities and Investments Commission Act.
\(^{39}\) It is worth noting that ASIC’s particular arguments and pleadings in this case were very specific and, at times, the judge seems to be indicating that different conclusions may have been reached if the case had been run differently.
<table>
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<tr>
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<tbody>
<tr>
<td>(i) Failing to disclose 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;</td>
<td>(i) The judge rejected these claims on the facts.</td>
</tr>
<tr>
<td>(ii) Citi’s interest in Patrick’s share price increasing was contrary to the interest of Toll, who would want Patrick’s share price to remain low, thus increasing the bid premium Toll was prepared to offer against the pre-bid market price;</td>
<td>(ii) The judge found that ASIC had not established that Toll had the interest alleged because Toll had used an earlier date as the reference date for the bid price;</td>
</tr>
<tr>
<td>(iii) Once Citi had acquired a substantial holding in Patrick shares, Citi’s interest conflicted with its duty to provide disinterested and loyal advice to Toll (for example, that the bid price should be increased).</td>
<td>(iii) The judge found that there was no evidence that there was a risk that the views of Citi’s senior management on the bid price would be sought.</td>
</tr>
</tbody>
</table>

3 **Informed consent**

If Citi was a fiduciary, it would need to obtain Toll’s informed consent to its actions

Again, the judge made observations on this even though he was not required to.

The judge observed that Toll’s informed consent to Citi’s proprietary trading could be inferred from the circumstances. Toll knew of Citi’s structure and method of operations. In addition, Toll was very experienced in M&A transactions.

The judge also makes some limited observations about the usefulness of information barriers as a means to managing conflicts of interest (at least in the context of the Australian law):

- The “management” of conflicts does not require that they be eliminated
- Information barriers can be effective to manage conflicts
- Formal policies alone are not enough; there needs to be real engagement with the business for them to be effective. This would include:
  - The physical separation of the relevant departments
  - A continuing education programme to emphasize the importance of not improperly or inadvertently disclosing confidential information
  - Strict and carefully defined procedures for dealing with situations where the “wall” should be crossed, and maintaining proper records of this
  - Monitoring by compliance officers of the effectiveness of the barriers
  - Disciplinary sanctions where there has been a breach.

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40 ASIC was not alleging a conflict of Citi’s duty, but it is more appropriately characterised as a divergence of the commercial interests of Citi and Toll.

41 Although the investment banking business of Citi was not the subject of a licence, and thus the provision requiring management of conflicts of interest did not technically apply.
The client would ordinarily need to consent (whether this is express or implied) to the use of information barriers as a means of managing the conflict.

Mr. Justice Jacobsen states at [454]:

*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.*