

A question of basic duty and financial trust

Noel Pearson

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Institutions handling both side of a deal must avoid conflicts of interest.

“I never will forget how this salesman looked me in the eye and, with a serious sense of pride, almost a tear, summed up this particular PERLS trade.

“Frank,” he said, “I ripped his face off.”

– *Frank Partnoy, former Morgan Stanley derivatives trader*

Like any ordinary person hearing the horror stories of the global finance industry over the past two years, an obvious question came to mind: why are investment banks allowed to “rip the faces off” their own clients?

I wondered why the law of fiduciary obligations did not prevent the finance industry’s double-sided dealings that exploded into public view during the global financial crisis like pustulating cankers on the body of the world economy.

Organisations such as Goldman Sachs, incomparably described by Matt Taibbi of Rolling Stone as “a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money”, play multiple sides on deals. They discovered, like the African-American fight promoter Don King, it is more lucrative to represent the fighters in both the red and blue corners, as well as making the whole market at Caesar’s Palace. Which left Australian pugilist Jeff Fenech to discover for himself the reason Larry Holmes once gave for the not-so-reverend King’s vertical hairstyle: “To hide his horns”.

Why didn’t these institutions owe basic duty to their clients?

Fiduciary duties involve a legal relationship where a vulnerable party is entitled to trust that a fiduciary party whose aid, advice or protection is sought in some matter, will act at all times for the benefit of the party that is owed the duty. The fiduciary must act in good faith and avoid conflicts of interest.

Fiduciary relationships include those between trustees and beneficiaries, legal guardians and wards, lawyers and clients, directors and companies, stockbrokers and clients, doctors and patients, parents and children and teachers and students. The list is long and not exhaustive. Former chief justice Anthony Mason said in one famous case that “the law has developed case by case, largely by analogy, it being accepted that the categories of fiduciary relationships are not closed”.

Lawyers are said to be the worst of the bottom feeders. But a lawyer can’t act for a client and then take a position against his or her interests at the same time. And yet it seems clients of investment banks are not entitled to the same expectation.

The obligations of investment banks to their clients was the subject of the 2007 Federal Court decision in *ASIC v Citigroup*.

ASIC started proceedings against Citigroup over its conduct when advising Paul Little’s Toll Corp in its acrimonious takeover of Chris Corrigan’s Patrick Corp. While the so-called “private side” of Citigroup was advising Toll on the takeover and thereby had access to highly sensitive information that was not available to the market, its “public side” had traded in the target company’s shares to Toll’s detriment. ASIC alleged that Citigroup breached its fiduciary obligations to Toll and engaged in insider trading.

Justice Peter Jacobson ruled against ASIC on the ground that Citigroup had contracted out of any fiduciary obligations to Toll in the terms of its engagement letter. All of the other grounds put forward by ASIC also failed.

Putting aside the inept way in which ASIC prosecuted Citigroup, if this case represents the true state of Australian law, it is highly unsatisfactory and plainly in need of reform.

I will refer to two reform proposals. First, whether and what fiduciary-type obligations financial institutions owe their clients. Second, whether and how proprietary trading by financial institutions should be allowed.

On the first question, financial institutions that market securities plead they are in the business of trade, and not profession. They put themselves out in the marketplace with all the trappings of professionals and yet plead they are merely traders.

This chameleonic charade is highly misleading and must end.

Melbourne University legal academic Pamela Hanrahan is sceptical, however, about the wisdom of importing fiduciary law concepts into the regulation of securities. Fiduciary obligations concern the private legal relationship between those that owe and those that are owed obligations. It depends upon the particular circumstances of the case whether one party has put itself in a position of owing a duty to another party.

Fiduciary-sounding provisions have been proposed by the parliamentary joint committee on corporations and financial services in its November 2009 report on the inquiry into financial products and services in Australia.

I say the Corporations Law should simply provide that financial institutions cannot contract out of any fiduciary obligations they may owe to their clients. Whether they owe such duties and what they are can then be determined by the courts. If an institution has, through a course of dealings, put itself in the position of fiduciary, then it should be held to account, and not escape by means of small print.

On the second question, the high watermark of reform would be to succeed where US President Barack Obama has failed: to ban proprietary trading by financial institutions.

In the absence of such a ban, then reform must focus on the fiction of maintaining Chinese walls in institutions that undertake proprietary trading.

As the Citigroup case showed, it is in the nature of private advisory businesses that highly sensitive commercial information is available to advisers and not to the market at large. The conduct of public side trading in the shares of client companies and their targets on the basis that Chinese walls provide the necessary separation between potentially conflicting interests -- let alone inside trading -- has stretched credulity for long enough. These walls are no more than a fig-leaf for conflicted practice.

The principal detriment is not to the clients of investment banks, but to the integrity of the market at large. Why should the market pay for ongoing chicanery in the trading of securities, when it can be completely excluded?

The Citigroup case laid down the following requirements concerning Chinese walls:

- Physical separation of departments;
- Recurring educational programs for staff;
- Procedures to deal with breaches;
- Monitoring by compliance officers; and
- Disciplinary sanctions for breaches.

This list makes for a flimsy wall. Physical separation of workspaces? Should the advisers and traders not go to the same pubs after work, have dinner parties together, spend time in the same rugby locker rooms?

Try Melbourne's Mitre Tavern or downstairs at the Sydney GPO on a Thursday evening when the drinks are flowing and see if any Chinese walls are still erect by 9pm.

Who really believes self-interest can and will be restrained by education programs when people whose business it is to make money are placed in the most invidiously tempting positions?

In the Citigroup case, the decisive moment came the day before the Toll bid for Patrick was publicly announced, when the trader's boss had the famous "cigarette on the pavement" discussion and told him to stop buying Patrick shares.

The trader then went upstairs to the dealing room and sold down some of his position.

The Corporations Law should simply ban investment banks from any trading in the shares of client companies and any target companies from the moment they are engaged as advisers.

Former trader Frank Partnoy categorised those who purchased dodgy derivative notes sold by Morgan Stanley as either "cheaters" or "widows and orphans".

His conclusion: “The cheaters are the people trying to get around [investment] guidelines, and the widows and orphans are the people who didn’t understand how the notes worked.”

Noel Pearson is director of the Cape York Institute for Policy and Leadership.