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Selling Complex Financial Instruments to Wholesale Clients

A paper by John Walker of IMF (Australia) Ltd presented to:

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1. Introduction

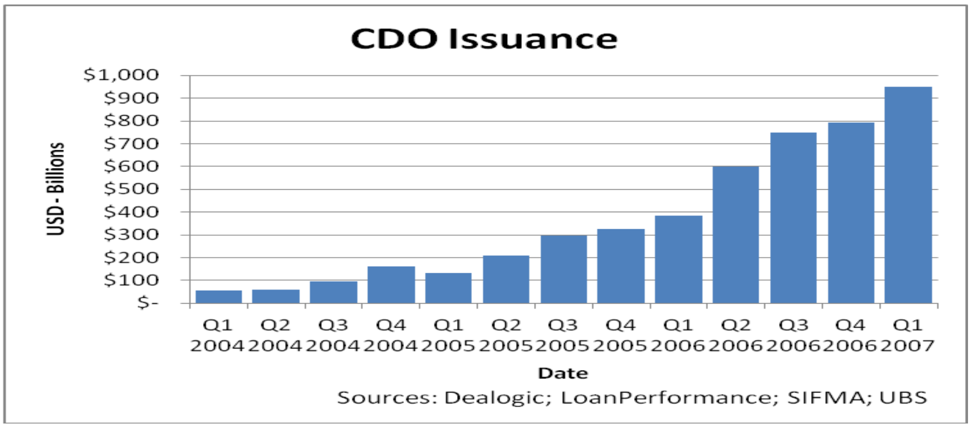
My presentation today addresses the distribution of complex financial instruments (CFI's) to wholesale clients by banks and financial service providers.

This area has become topical and potentially of interest principally due to the spotlight placed on this market as a result of the fall-out from what became known as the global financial crisis (the "GFC"). Dysfunctional markets identified in the GFC provided the opportunity for industry, regulators, investors and legislatures to review the manner in which credit was created and priced leading up to and during the GFC, identify short comings and make necessary changes.

An example of CFI's to be used today are collateralised debt obligations, better known as CDOs. The general features of CDO's are described at **Attachment 1**. We don't have enough time today for me to describe in detail CDOs, but you can take it as read that CDOs are complex financial instruments.

Warren Buffett is best known for his description of derivatives as weapons of mass financial destruction but he also pointed out that "on a CDO squared, you have to read 750,000 pages to understand the instruments that were underneath it".

CDO issuances went from about US$70bn in the first quarter of 2004 to about US$960bn in the first quarter of 2007.



Financial regulators around the world fought to provide transparency for these and other CFI's but the dramatic expansion in CFI markets meant there was little or no critical debate with other than a small population of insiders, with the rest of us left with a bewildering list of acronyms and other jargon leaving meaning impenetrable.

Most synthetic CDOs were sold in private transactions, without any registration procedure or ready access to the underlying documentation.

Investors were often assured of liquidity but quickly found there was none. Even those synthetic CDOs which were listed on the securities' exchanges, were essentially illiquid. Secondary exchanges occurred off market, without published sales.

As arrangers insisted on individual sales in Australia to be in excess of $500,000, presumably to avoid the Investor Protection Regime for Retail Investors,[1] there was no need for a prospectus or even a comprehensive selling document to be created and distributed.

Investors often bought these products without any explanation at all as to how they operated as the Investor Protection Regime does not currently protect investors that are sophisticated,[2] advised by a financial services licensee[3] or are professional investors.[4]

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[1] The Investor Protection Regime for Retail Investors commences in Part 6D.2 of the Act which broadly requires disclosure of a prospectus (context – sections 710, 711, 713); a short form prospectus (section 712), a profile statement (section 714) or an offer information statement (section 715). Importantly, section 728 makes illegal misleading or deceptive section 729 enables claims for compensation for any breach of section 728.

The Investor Protection Regime also relevantly continues in Parts 7.6 to 7.10 of the Act providing Retail Investors with the benefit of Australian Financial Services Licensing (s911A), obligations (s912A), compensation arrangements (s912B), financial services guides (s942B).

Finally, the Investor Protection Regime addresses advice given to retail clients, either personally (s766B(3)) or generally (s766B(4)). Section 95A requires financial advisers to only provide personal advice where they have made reasonable inquiries about their client's personal circumstances (s945A(i)(a)(ii)) and considered and investigated the subject matter of that advice (s945A(i)(b)) (respectively known as "know your client" and "know your product").

[2] (i) where they invest at least $500,000; or
(ii) where they have at least $2.5m in net assets or a gross income for each of the last 2 financial years of $250,000; (refer s708(8)).

[3] (i) where the offer is made through a financial services licensee;
(ii) the licensee is satisfied on reasonable grounds that the person to whom the offer is made has previous experience in investing in securities that allows them to assess:
(a) the merits of the offer;
(b) the value of the securities;
(c) the risks involved in accepting the offer;
(d) their own information needs;
(e) the adequacy of the information given by the person making the offer;
(iii) the licensee gives the person before, or at the time when, the offer is made a written statement of the licensee's reasons for being satisfied as to those matters; and

This lack of transparency in both the CDS and CDO markets came home to haunt the global financial system. At the height of the GFC, no one truly knew what instruments had been created, their terms, their amount, their longevity or the parties who were liable under them. My call for legislative reform is in section 4 below under the heading "The Legislative Spotlight".

2. CDOs and the GFC

By late 2006, early 2007, concerns over losses on US subprime mortgage loans, escalated into widespread financial stress, raising fears about the stability of banks and other financial institutions.

The contagion quickly spread across other credit segments and broader financial markets to the point where sizeable parts of the financial system became largely dysfunctional. This period became known as the Global Financial Crisis.

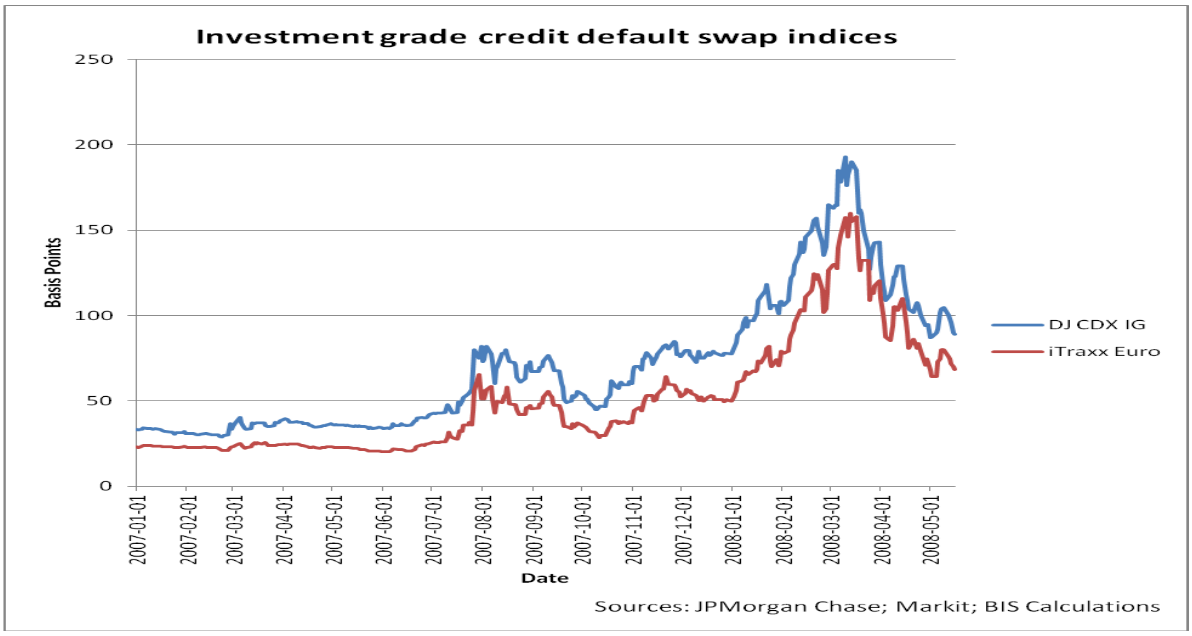
In an environment of rather accommodative financial conditions and elevated risk appetite, use of credit derivatives and securitisation had aided the build-up of substantial leverage in the financial system as a whole.

When this leverage started to be unwound, price deterioration led to margin calls and further deleveraging. With liquidity evaporating, valuations came under greater pressure and a period of disorderly pricing commenced.

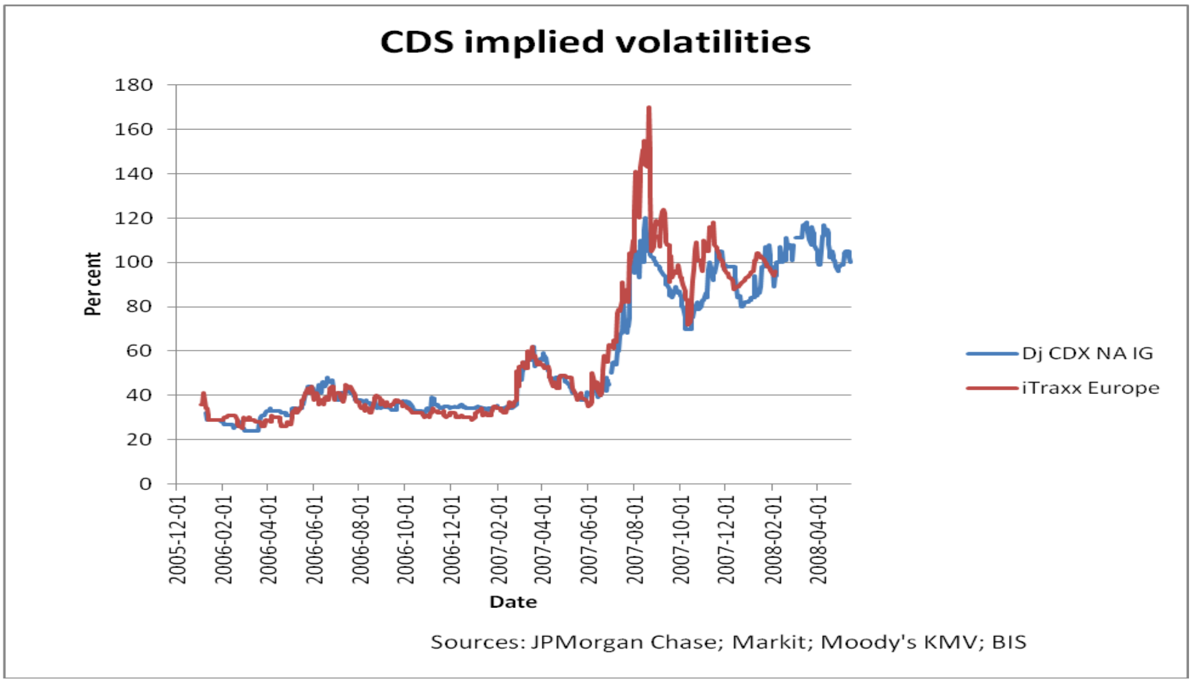
In the process, credit spreads across markets widened markedly and demand for new CDO issuances evaporated.

(iv) the investor signs a written acknowledgment that the licensee has not given the person a disclosure document in relation to the offer; (refer s708(10)).

[4] Includes a person that controls at least $10m, or is a listed entity (refer s.9 definition).



Increasing spreads coincided with a substantial increase in volatilities implied by credit default swap (CDS) index options.



Even though markets recovered somewhat,[5] credit spreads rose by mid-May 2008 to levels comparable to the higher range of those seen in earlier cycles, consistent with market perceptions of a pronounced increase in default risk.[6]

[5] Although some have not recovered. For example, house prices in the US remain about 34 percent below their July 2006 peak (S&P/Case – Shiller index)

[6] This overview was obtained from BIS 78th Annual Report.

3. Why Wholesale Clients Invested in CDOs

The investor could have deposited its money with a bank for a long fixed term and obtained close to the bank bill rate from time to time.

There were essentially four reasons (other than the extra 100 or so basis points received by way of coupon) why wholesale clients "invested" in synthetic CDO's:

(a) because a bank had lent its name to the transaction and was promoting the deal;

(b) because they had been mis-described as, or similar to, floating rate notes;

(c) because they had received a AAA rating from one or more of the rating agencies; and/or

(d) because they were advised to do so by an "independent" adviser.

The better part of valour leads me to not elucidate currently upon the banking industries' promotion of CDOs. For present purposes, it was not sufficiently clear to clients of banks that the banks or other financial service providers were acting purely in their own interests when arranging or distributing CFI's. Further, the banks often failed to make clear to their "clients" all of the information required in order for them to make an informed investment decision.

Investors in Australia understand that floating rate notes are generally issued by large Australian corporations on the basis that the corporation will pay interest on the note and then repay the amount of the note at its expiry. The investor is taking the risk that the corporation will be able to pay. That is the only risk that the investor takes with a floating rate note.

With a synthetic CDO, the funds raised by the issuer are not lent to any business entity. The funds are simply put on deposit in order to earn interest.

The risk that is taken by the investor is the risk that the nominated number of defaults will occur amongst the list of companies referred to in the CDO.

If the investors' money was lent in equal amounts to say 150 companies, then if say 30 companies defaulted, the investors would get back 80% of their investment (i.e.: the other 120 companies would repay their debt).

In a synthetic CDO, it takes only eight defaults from that 150 to lose the entire investment. Therein lies the imbedded leverage risk in CDO's that investors did not sufficiently understand.

Ratings Agencies typically rated CDOs AAA which for present purposes is an opinion that it is almost certain that investors would get their capital returned and coupons paid. The Ratings Agencies simply failed in their task.

Normally of course, when Ratings Agencies rate a floating rate note, they establish the likelihood of the company in question being able to repay its debts.

There is no such activity by Ratings Agencies in relation to CDO issuers because those issuers always have no ability to repay whatsoever, other than from the investors own money. They are built that way – they are built with no capital and no assets.

Finally, the role played by advisers requires investigation. Unfortunately, some of the advisers were associated with the arrangers (as was Lehman Australia with its holding company) and had business models that had them selling for the arrangers and advising the buyers (unfortunately dealing on both sides of the desk).

It was a combination of these four factors which enabled arrangers to sell synthetic CDOs in Australia to organisations that simply did not know enough about what they were buying.

Thankfully the market has evaporated and the selling practices are under judicial spot lights and hopefully will be under a legislative spotlight in the not too distant future. I will first address the legislative spotlight, then frame the discussion within current common law and equitable relationships that may be relevant followed by a query concerning the Code of Banking Practice and finally use the Lehman and ABN Amro Federal Court claims by way of examples.

4. The Legislative Spotlight

The Corporations Act draws a distinction between unsophisticated, non professional investors ("**Retail Investors**") and sophisticated, professional investors ("**Wholesale Investors**") when identifying who is to obtain the benefit of the Investor Protection Regime[7] within the Act. The policy consideration behind this demarcation is based on an assumption that regulatory protection of Wholesale Investors is an unnecessary fetter on the banking and financial services industries.

The current law excludes protection for potential investors in circumstances including, broadly, where they are sophisticated, are advised by a financial services licensee, or are a professional investor.

This law is appropriate for the sale of vanilla equity or debt securities but is not appropriate in respect of the sale of complex financial instruments ("**CFI's**") which are only capable of realistically being understood real time by the arranger. Even the ratings agencies have been shown to be unable to price risks associated with CFIs.

I will use collateralised debt obligations (**CDOs**) sold by Lehman and constant proportion debt obligations (CPDOs) arranged by ABN Amro Bank NV ("ABN") as examples of CFI's to explain why the Investor Protection Regime was and remains inadequate when the bank and financial services industries are distributing CFIs to Wholesale Investors. The essence of a CDO is an embedded credit default swap which is described at **Attachment 1**.

[7] As defined in footnote 1.

The statutory exceptions to the Investor Protection Regime focus on the characteristics of the investors and disregard the characteristics of the investment. This limitation has meant that hundreds of Australian churches, councils, charities and other people and entities, without the capacity real time to understand the merits, value and risks associated with purchasing CFI's from banks either directly or through financial intermediaries, have lost hundreds of millions of dollars in Australia alone.

It is time for the legislature to consider whether the statutory exceptions to the Investor Protection Regime need amendment, so far as they relate to CFI's.

It is time because:

(a) the banking industry, ratings agencies and financial services licensees have evidenced an incapacity to be responsible for pricing risk in respect of CFI's; and

(b) most Wholesale Investors, let alone Retail Investors, are similarly incapable.

The Investor Protection Regime ought not only focus on who is buying, but also on what is being sold, even if they are provided with a full set of the relevant documentation. The Regime needs to protect investors who are not able to assess CFI's, even if they are provided with a full set of relevant documentation, in respect of:

(i) merits, value and risks associated with the offer;

(ii) their own information needs; and

(iii) the adequacy of the information given by the seller (the "**Assessment Capabilities**").

That is easily said. The banking and financial services lobby may see it in its interest to continue to lobby for an objective demarcation enabling the industry to sell CFI's to churches, councils and charities on the basis that the demarcation sought is too subjective and incapable of sufficiently precise definition.

Where then ought the line be drawn? That line ought to be drawn by reference to the purpose of the Investor Protection Regime having regard to the legitimate interests of the financial services industry not to be unnecessarily regulated.

There is no legitimate interest in the financial services industry selling CFI's to churches, councils and charities. That opportunity ought not remain.

It behoves the industry to constructively engage in policy dialogue to position the investment flags on the beach outside which sellers can only sell CFI's to people with Assessment Capabilities and between which you may swim within the Investor Protection Regime.

5. Advisory Duties

5.1 Introduction

Banks and other financial service providers ("**Distributors**") create relationships with "clients" which too often cloud the legal basis on which CFI transactions occur.

Distributors perceive their role as arm's length vendors, placement agents or brokers in respect of CFI's when they deal with Wholesale Clients, whereas "clients" often see themselves as just that; clients of the banks and other financial service providers.

At common law and in equity, Courts identify the relevant legal or equitable relationship by focusing on the relevant circumstances and it turns out more regard is had to the clients' perceptions than the Distributors.

This issue is particularly sensitive where CFI's are concerned as reliance by clients on Distributors is prevalent for an understanding of the merits, value and risks associated with the offer.

The duty to exercise reasonable or due care and skill in providing investment advice and recommendations is clear when Distributors contract to provide professional advice.[8] The issue as to where the line is drawn between arm's length vendors and advisers at common law and in equity is discussed below.

5.2 Common Law Duty of Care

Pleadings alleging facts relevant to the existence of an advisory relationship usually go something like this:

1. When the bank was providing advice about the CFI or recommended the CFI to the claimant, it knew the claimant would rely upon:

   (a) any information the bank provided about the CFI;

   (b) any recommendation made by or advice given by the bank about the CFI;

   (c) the bank to provide all material information about the product that might reasonably be considered as bearing upon whether the claimant should invest in the CFI; and

   (d) the bank to provide accurate information about the CFI.

2. The bank also was aware that:

   (a) any information the bank provided about the CFI on any recommendation it made would have been a significant consideration for the claimant in deciding whether to invest;

[8] As did Lehman Australia with its mandate clients.

(b) the claimant didn’t have the capacity to understand the operation of and risks associated with the CFI and was therefore dependent upon the bank to accurately and completely disclose and explain such matters; and

(c) as a potential purchaser of investments from the bank, the claimant would risk incurring economic loss if the statements or recommendations were incomplete or inaccurate.

3. As a result of the existence of the circumstances in 1 and 2, the bank owed the claimant a duty to exercise the reasonable skill and care to be expected of an experienced financial services provider to:

(a) properly assess and analyse any CFI the bank is considering recommending to the claimant;

(b) ascertain and understand the investment profile and preferences of the claimant, as well as any legislative or other restrictions upon its power to invest;

(c) satisfy itself that the CFI is a suitable investment for the claimant and only recommend a suitable investment;

(d) provide the claimant with all material information about the CFI relevant to the claimant’s decision;

(e) identify the rules and accurately and completely disclose and explain the risks to the claimant; and

(f) avoid recommending a CFI where the bank:

(i) did not know whether the investment was suitable; and/or

(ii) knew that the CFI was too complex and sophisticated for the claimant to be able to understand the operation of and risks associated with the investment and thereby make an informed decision whether to invest.

5.3 Banker's Fiduciary Obligations

(a) Introduction

The unanimous Full Court decision in *Commonwealth Bank v Smith*[9] considered the factual circumstances that led to the primary Judge formulating the position that the lending banker had created a "reasonable expectation" in the mind of the customer that he would act in the customer's interest when giving advice about purchasing a business to which the bank was the existing primary lender.

These factors included:

(i) a longstanding relationship between the banker and customer;

(ii) the customer's lack of business experience;

(iii) the fact that the banker freely offered his advice on aspects of price and desirability of the investment; and

(iv) the customer's actual reliance and faith in the advice provided by the banker.

The Full Court found on the facts that the banker had provided investment advice, and that the relationship and the circumstances of the transaction had created a "reasonable expectation" within the customer that the banker was acting in the customer's best interest when advising and pursuing the transaction.

[9] (1991) 42 FCR 390

The Full Court explained that in addition to contractual duties owed by bankers to customers, the factual circumstances of the relationship may give rise to the imposition of fiduciary duties. At paragraph 391 of the joint judgment of Davies, Sheppard and Gummow JJ, their Honours stated that:

> "*A bank may be expected to act in its own interests in ensuring the security of its position as lender to its customer, but it may have created in the customer the expectation that nevertheless it will advise in the customer's interests as to the wisdom of a proposed investment. This may be the case where the customer may fairly take it that to a significant extent his interest is consistent with that of the bank in financing the customer for a prudent business venture. In such a way the bank may become a fiduciary and occupy the position of what Brennan J has called "an investment adviser": Daly v Sydney Stock Exchange Ltd (1986) 160 CLR 371 at 384-385."*

The above statement of the Full Court has been instrumental in the determination of many subsequent decisions.

(b) *Subsequent Cases*

The reasonable expectation criterion as a basis of finding the existence of a fiduciary relationship has received consistent favourable affirmation in subsequent case law both in Federal and State Courts. Whilst the vast majority of the cases have endorsed the concept of reasonable expectation as developed in *Smith*, Courts have applied the principle on a case by case basis and fiduciary relationships have only been found when the case exhibits the requisite factual circumstances.

The cases identified in footnote[10] 9 are select decisions of superior courts that have specifically considered the reasoning behind the *Smith* decision. These decisions affirm the legitimacy of the "reasonable expectation" approach to equity identifying fiduciary relationships in respect of parties giving advice in regard to financial transactions in particular. Austin J succinctly addressed the issue when he said:[11]

> *"The fiduciary relationship between financial adviser and client arises because the financial adviser, having held itself out as an adviser on matters of investment, undertakes a particular financial advisory role for the client: Daly v Sydney Stock Exchange Ltd, 160 CLR at 377 per Gibbs CJ; 384-385 per Brennan J. The advisory fiduciary relationship may arise whether or not there is an anterior fiduciary relationship between the parties, such as the relationship of broker and client. The relationship can arise even where parties are dealing with one another in a transaction in which the adviser has an obvious commercial self-interest. Thus, 'a bank may be expected to act in its own interests in ensuring the security of its position as lender to its customer, but it may have created in the customer the expectation that it will nevertheless advise in the customer's interests as to the wisdom of a proposed investment': Commonwealth Bank of Australia v Smith (1991) 42 FCR 390, 391"*.

(c) *Smith's Relevance To Banks Selling CFI's*

The facts consistent with this finding which may be in existence when a bank is distributing CFI's to non retail clients include where:

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[10] *Territory Sheet Metal Pty Ltd v Australian New Zealand Banking Group Pty Ltd* [2009] NTSC 31 at [1437] and [1438]; *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd* (2007) 160 FCR 35 at [285]; *Advanced Switching Services Pty Ltd v State Bank of New South Wales t/as Colonial State Bank* [2007] FCA 954; *Timms v Commonwealth Bank of Australia;* [2004] NSWSC 76 at [171]; *Australian Competition and Consumer Commission v Oceana Commercial Pty Ltd* [2003] FCA 1516 at [319]; *Truebit Pty Ltd and Ors v Westpac Banking Corporation – [1997]* BC9706241 at [30];

[11] *Aequitas Ltd v Sparad No 100 Ltd (formerly Australian European Finance Corp Ltd)* [2001] NSWSC 14 at [307].

(a) the case "is not one where one would properly describe the parties as acting in a commercial transaction at arm's length and each with the assistance of fully independent professional advice";

(b) the bank introduced the CFI to the investor;

(c) the bank advised the investor concerning the CFI;

(d) the investor is a long term customer of the bank having only purchased fixed interest notes previously; and

(e) the investor, although "wholesale" under the Act is incapable of understanding the risks inherent in the CFI.

(d) What Fiduciary Duties Arise?

In Smith, the critical incident of the fiduciary relationship "*arose from the conflicting interests between the two sets of customers of the bank*" (i.e. the vendor and the purchaser were customers of the bank). The relevant duty in Smith was "*a duty not to eschew conflicting engagements*" (i.e. "*the avoidance of conflict of duties*").

Where a bank is distributing CFI's, the relevant duty of the bank, if it is found to be fiduciary, is to not let the interests of the investors conflict with its interests as vendor unless it is absolved by the giving of fully informed consent.

"*This is a question of fact… and of all the material facts and circumstances of the case.*" The circumstances of the case may include the importance of the client obtaining independent and skilled advice from third parties or the bank at least advising the client to do so.

5.4 Code of Banking Practice Duties

The obligations of financial services licensees contained in section 912A of the Corporations Act are only applicable in respect of the licensee dealing with Retail Investors.

The provisions of the Code of Banking Practice (the "**Code**") apply with contractual force to banks in their dealings with Wholesale Investors with less than 20 full time people ("Small Wholesale Investors").

Relevantly, clause 2.2 of the Code requires banks to act fairly and reasonably towards Small Wholesale Investors in a consistent and ethical manner.

This obligation may realistically encompass an obligation by banks to act in good faith which in turn may require banks to fulfil the six duties noted at 5.2.3 without the need to prove the facts in 5.2.1 or 5.2.2.

In other words, the Code of Banking Practice may have introduced a duty of care for banks dealing with Small Wholesale Investors.

For the reasons I noted in section 4 above, this possibility should not cause concern to banks where the dealings involve CFI's and the Small Wholesale Investors don't have Assessment Capabilities (as defined in section 4 above).

6. The Lehman Spotlight

6.1 Introduction

Lehman Australia's ("**Lehman's**") business model involved the distribution of synthetic collateralised debt obligations (**SCDOs**) to its church, council and charity client base (the "**CCCs**") who were charged with the management and investment of public money, with trustee type obligations. Whilst the CCC's were Wholesale Investors under the Corporations Act, they lacked the capacity to assess CFI's in respect of Assessment Capabilities (as defined in section 4 above).

Lehman received underwriting fees from investment banks for distributing SCDOs in Australia, accounting for about 97% of its income. In 2007, Lehman's was taken over by Lehman Brothers Inc. and thereafter exclusively distributed for Lehman Brothers Inc. SCDOs for it. Lehman's business, therefore, wasn't really about advising clients.

The CCC client base, however, provided a convenient and captive audience for the sale of SCDOs. Lehman promoted itself as an expert in advising such clients and recommended the SCDO products to them on the basis of its specialised knowledge.

Lehman said it was familiar with its CCC clients' requirements, including their need for liquid and secure investments. To that end, it had to (and did) promote the SCDO products as liquid investments with risk profiles as safe as, or safer than, corporate bonds and floating rate notes.

These matters were not true. The products were not liquid. The promotion of the SCDOs by Lehman on the basis of the rating applied by the rating agencies elided many of the risks associated with them. Lehmans knew all these matters but did not disclose them to its CCC clients.

Prior to the involvement of Lehman, each CCC demonstrated a conservative investment history. The funds invested were surplus funds and had to be redeemable at short notice.

The value of CDOs dropped dramatically in 2007 and 2008, with CCCs losing about 50 percent of the $1.2bn they invested through Lehman in CDOs.

The CCCs were Wholesale Investors but the reality was that the officers involved had little or no understanding of the workings and complexity of the products which they were recommended by Lehman.

Lehman initially entered into a Deed of Company Arrangement with its creditors which purported to grant other Lehman entities releases. The High Court of Australia subsequently agreed that the DOCA ought to be set aside as outside power. This enabled 72 of the CCC's to join together in a class action against Lehman and its liquidators seeking damage awards for breach of contract, negligence, misleading and deceptive conduct and breach fiduciary duty.

6.2 Claims in Contract and Negligence

(a) Relevant principles

The principles can be shortly stated. Lehman, as a professional adviser, had an obligation to each of the CCCs to exercise reasonable or due care and skill in providing its investment advice and recommendations.

The obligation to exercise reasonable care and skill is implied by operation of law and a co-extensive duty to exercise reasonable care and skill arises in tort.[12] Where a wrongdoer is liable concurrently in both contract and tort, damages cannot be reduced for contributory negligence: see *Astley* at 38 [89].

(b) IMP Clients

Lehman entered into written investment advisory agreements ("IMPs") with some of its clients, thereby securing mandated funds with delegated investment authority to provide services in accordance with guidelines.

A professional adviser exercising due care and skill allegedly would not have made the investments by putting the mandate funds into products such as SCDOs, which were riskier than other fixed interest products, when other alternative and more suitable investments were available.

(c) Was there a duty of care (in tort or under contract) as alleged?

Unlike the IMP claims, Lehman denied that any duty of care was owed to non IMP investors.

Lehman however, was alleged to have held itself out as an expert able to give advice in respect of the products it recommended, including the

[12] See *Astley v Austrust Ltd* (1999) 197 CLR 1 at 22 [47].

SCDOs. It did give such advice consistently over a period of years. In so doing, it assumed a duty[13].

Lehman asserted that it was merely a “seller”, “placement agent” or “broker” in respect of the SCDO products for Non IMP CCCs. However, when regard is had to the facts and circumstances it is clear a duty of care arose[14].

6.3 Misleading and Deceptive Conduct

(a) Relevant principles

It is common ground that Lehman’s communications in relation to the SCDOs were in respect of a financial product or financial service within the meaning of ss 763A and 766A of the *Corporations Act* 2001 (Cth) or financial service within the meaning of s 12DA of the *Australian Securities Investment Commission Act* 2001 (Cth). The conduct complained of also fell within the relevant State Fair Trading Acts.

The CCCs’ allegations of misleading and deceptive conduct thus arise under ss 1041H of the *Corporations Act* 2001; 12DA of the *ASIC Act* 2001, s 42 of the *Fair Trading Act* 1987 NSW and s 10 of the *Fair Trading Act* 1987 WA.

There is no relevant difference between causes of action under the *Corporations Act* 2001 (Cth) and the *Trade Practices Act* 1974 (Cth) (now the *Competition and Consumer Act* 2010 (Cth)).[15]

The courts have consistently stated that it is inappropriate to attempt to provide an exhaustive definition of what is misleading or deceptive conduct. All the circumstances will be examined to determine whether conduct is misleading or deceptive.[16]

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[13] See *Tepko Pty Ltd v Water Board* (2001) 206 CLR 1; see also *Kestrel Holdings Pty Ltd v APF Properties Pty Ltd* (2009) 260 ALR 418.

[14] See the discussion in *Eric Preston Pty Ltd v Euroz Securities Ltd* (2011) 274 ALR 705 at [159]-[167].

[15] *GPG (Australia Trading) Pty Ltd v GIO (Holdings) Ltd* (2001) 117 FCR 23.

[16] *Fraser v NRMA Holdings* (1995) 55 FCR 452.

Although evidence that a person has actually been misled does not conclusively establish that the conduct is misleading or deceptive or likely to mislead or deceive, nevertheless such evidence may be relevant and persuasive.[17]

(b) Did Lehman engage in misleading and deceptive conduct?

Each of the CCCs was told that the investments in SCDOs were liquid and that there was an active secondary market. Lehman well knew that liquidity was a fundamental pre-condition for any investment by councils in the product.

The representations to the CCCs about the equivalence of the investment in SCDOs to other products elided many known facts about the limitations of the ratings. Lehman knew that the ratings of S&P was limited to first dollar loss and did not deal with all risks.

Lehman's presentations presented it as a specialist adviser, yet it offered no warnings that investors would be paying a premium above the price implied by the credit spreads on the underlying portfolio.

6.4 Fiduciary Duty

(a) IMP Clients

IMP Clients contend that Lehman was in a fiduciary relationship with them by proposing and entering into the respective IMP Agreements.

The starting point is that a fiduciary relationship arises between an adviser and its client where the adviser holds himself out as an expert on financial matters and undertakes to perform a financial advisory role for the client[18].

The adviser owes such duties because he undertakes to act in the client's interest and not solely in its own interests.[19]

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[17] *Global Sportsman Pty Ltd v Mirror Newspapers Pty Ltd* (1984) 2 FCR 82.

[18] See *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371 at 377 per Gibbs CJ, 385 per Brennan J; see also *Aequitas Ltd v Sparad No. 100 Ltd (formerly Australian European Finance Corp Ltd)* (2001) 19 ACLC 1006 at [307] per Austin J.

[19] See *Aequitas* at [310] and *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 96-97 per Mason J.

In *Hospital Products Ltd* at 97, Mason J observed that "*contractual and fiduciary relationships may co-exist*". The fiduciary relationship must conform to the terms of the contract. Thus, His Honour recognised:

> "The fiduciary relationship cannot be superimposed upon the contract in such a way as to alter the operation which the contract was intended to have according to its true construction."

As Jacobsen J recognised in *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35 at [278] it follows that it is open to the parties to exclude or modify the fiduciary relationship (that was the effect in that case where the exclusion was in the clearest of terms). Whether the exclusion operates depends upon the ordinary principles of contract construction.[20]

(b) Non IMP Clients

For the reasons stated above and noted below, Lehman also assumed an advisory relationship with Non IMP clients. It was clearly a relationship where CCC's put significant trust and confidence in Lehman. Lehman presented on numerous occasions to each of the CCCs. When doing so it gave advice and made recommendations about each of the investments. In the circumstances, the CCCs alleged their relationships with Lehman were properly characterised as fiduciary.[21]

(c) Did Lehman fail to obtain informed consent?

The obligations on the fiduciary are proscriptive in nature. They are:

(i) not to act in a position of conflict between its interests and duties and the interests of each of the Applicants; and

(ii) not to profit from its position of investment adviser and portfolio manager.

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[20] See *ASIC v Citigroup* at [281] and the authorities cited therein including those applicable to exclusion clauses – *Darlington Futures Ltd v Delco Australia Pty Ltd* (1986) 161 CLR 500 at 510.

[21] See *Daly* at 377 per Gibbs CJ, 385 per Brennan J.

A person occupying a fiduciary position will be absolved of liability for a breach of those obligations if he first obtains fully informed consent.[22]

Whether informed consent has been given will be a question of fact in all the circumstances of each case.[23] In order to be exonerated the fiduciary must give full or frank disclosure of all material facts.[24]

Nonetheless the fullness of the disclosure required may depend on the sophistication and intelligence of the person to whom disclosure is required to be made.[25]

None of the CCCs was fully informed by Lehman that:

(i) Lehman was earning substantial fees in relation to the underwriting, structuring and selling SCDOs;

(ii) Lehman's fees from dealing in the SCDOs were significantly greater than the fees and commissions it earned, or could have earned from dealing in term deposits and traditional floating rate notes;

(iii) Lehman was able to minimize or defray the risk of underwriting and holding SCDOs on its books by selling the SCDOs to the CCCs; and

(iv) the SCDOs involved significant risks.

(d) Did Lehman breach its fiduciary duty?

Lehman, in its position as fiduciary, had a conflicted role. It made very significant fees from promoting the sale and underwriting the placement of SCDOs. The risk factors identified above, including the liquidity risk were a significant matter of which each of the CCCs ought to have been made aware. In failing to make the adequate disclosures of these matters, the CCCs alleged Lehman breached its fiduciary duties. Additionally, by promising each of its clients "liquidity" and an "active secondary market" Lehman put itself in a further position of conflict because of its duties to its various clients. The assurances which it gave as to these matters meant that it had one client's funds to meet requests by other clients to "sell"

[22] See *Commonwealth Bank of Australia v Smith* (1991) 42 FCR 390 at 393.
[23] See *Maguire v Makaronis* (1997) 188 CLR 449 at 466.
[24] See *New Zealand Netherlands Society Oranje Inc v Kuys* [1973] 2 All ER 1222 at 1227 per Lord Wilberforce.
[25] See *Farah Constructions Ltd v Say Dee Pty Ltd* (2007) 81 ALJR 1107 at [107].

products and it also had to effect switch transactions in order to ensure that it had sufficient funds to meet such requests.

7. The ABN Spotlight

There will be another judicial spotlight on the conduct of an arranging bank in respect of the distribution of complex financial instruments in Australia when the reserved Federal Court decision in respect of the claims by twelve NSW councils against ABN Amro Bank N.V. and others is handed down.

The claim relevantly included a claim in negligence and for misleading and deceptive conduct that was heard over 12 weeks earlier this year.

The handing down of the decision is eagerly awaited and expected later this year.

8. Conclusion

If any one lesson can be taken from the massive expansion of credit risk created by the sale of CFIs to Wholesale Investors by banks in 2005 to 2007, it is that transparency ought to be directly proportionate to complexity. As the market for synthetic securitised derivatives grew in size proportionately with the complexity of the instruments, the banking and financial services industries failed to ensure Wholesale Investors were making informed buying decisions.

This occurred at a time when ratings agencies were also ill equipped to grapple with the burgeoning CFI markets and the banks' unquestionable skill in developing new and more complex products.

A perfect storm was created by debt markets freezing as market participants were incapable of identifying who was left with the unregulated off balance sheet credit risk as it crystallised. Transparency is not only needed at point of sale, it is needed continuously after the risk is synthetically created in order for markets to remain liquid.

The Market Protection Regulations ought not only focus on who is investing but also on what is being sold. The Regime needs to protect investors who are not able to assess CFIs in respect of their merits, value and risks associated with the offer; their own information needs and the adequacy of the information given by the arranger or distributor.

It behoves the industry to constructively engage in policy dialogue to position the investment flags on the beach outside which sellers can only sell CFIs to people with Assessment Capabilities and between which you may swim with the benefit of the Investor Protection Regime.

Dated: 3 August 2012

John Walker

Attachment 1 – General Features of CDO's

The structures of CDOs were complex with lengthy transaction documents setting out rights and obligations but in broad outline were as follows [*NB: these features are largely taken from the UK Supreme Court decision in Belmont Park – [2011 UKSC 38]*]:

(a) Lehman set up an SPV ("the Issuer") in a suitable jurisdiction;

(b) Investors ("the Noteholders") subscribed for Notes issued by the Issuer. The Notes were often issued with a margin over Australian dollar denominated 3 month bills;

(c) The Issuer used the subscription moneys to purchase government bonds or other secure investments ("the Collateral");

(d) The Collateral was vested in a Trustee ("the Trustee");

(e) The Issuer entered into a credit default swap agreement with a credit default swap counterparty by which that party would pay the Issuer the amounts due by the Issuer to the Noteholders in exchange for the payment by the Issuer to the credit default swap counterparty of sums equal to the interest received on the Collateral;

(f) The amount by which the sum payable under the swap agreement by the credit default swap counterparty exceeded the yield on the Collateral represented what has been described as the premium for credit protection insurance provided by the Noteholders;

(g) The amount payable by the credit default swap counterparty to the Issuer on the maturity of the Notes (or on early redemption or termination) was the initial principal amount subscribed by the Noteholders less amounts (if any) calculated by reference to the Credit Events occurring during a specified period by reference to one or more reference entities. In return, the credit default swap counterparty would receive the proceeds of the Collateral;

(h) The payment due from the credit default swap counterparty at maturity of the swap agreement (and also the outstanding principal amount of the Notes) could be reduced (in extreme circumstances to zero) during the term of the swap agreement (and the Notes) if Credit Events occurred and were notified in accordance with the terms of the swap agreement;

(i) Credit protection or insurance is a misnomer because there was no requirement for credit default swap counterparty to have any direct exposure to the reference portfolio: it was expressly provided that the swap did not constitute a contract of insurance and that payments would be due in the event of Credit Events without proof of economic loss to the credit default swap counterparty;

(j) There was in effect an "excess" because the notified Credit Events would lead to a reduction only if they exceeded a stated "subordination amount";

(k) If Credit Events did not occur the Noteholders were due to receive the full amount of the Notes, and the credit default swap counterparty was to put the Issuer in funds to redeem the Notes;

(l) If Credit Events occurred, the amounts payable by the credit default swap counterparty and the principal amount due on the Notes were to be reduced from time to time as and when such Credit Events occurred and were notified;

Consequently the performance of the Notes was linked to the performance of the obligations of the reference entities. In effect, the credit default swap counterparty was speculating that sufficient Credit Events would occur for it to be required to pay less than the Noteholders had invested and to net a substantial part of the Collateral; and the Noteholders were speculating that the credit reference portfolio was safe and that any Credit Events within it would not "burn through" the net amount of the subordination amount.