Paul Rogerson, Head of Legal, St George Bank, Sydney

Conflicts of Interest in financial Services Firms – a commentary

CONFLICTS OF INTEREST IN FINANCIAL SERVICES FIRMS

A COMMENTARY

BY

R P ROGERSON*
Head of Legal
St.George Bank Limited

* **The views expressed in this paper are the author's alone and do not necessarily reflect the views of his employer**

INTRODUCTION

As we have heard from Bob, the instances of conflicts of interest are not restricted to financial services firms. It can arise in many circumstances, as many of you in private practice know only too well. Much of what arises in private legal practice formed the basis of argument by counsel for ASIC in *ASIC v Citigroup*. Bob has dealt with that case at some length in his paper and I will not cover that again.

When considering conflicts of interest in financial services firms, we often think of the classic situations that can arise in investment banks with insider trading issues and the tensions that exist between the "public side" and the "private side". However, there are tensions within retail financial services organisations as well in managing conflicts of interest and with the enactment of Chapter 7 of the **Corporations Act 2001** (**Corporations Act**) the issue of conflicts management for retail financial service providers has exacerbated.

This paper will highlight the issue in the context of looking at the position of financial planners in Australia and in particular focus on whether a financial planner is a fiduciary. To the extent that New Zealand may contemplate following Australia in enacting legislation along the lines of Chapter 7, it could do well to look at the difficulties this legislation has caused for financial services organisations and the determine how much consumers have benefited with the increased level of disclosure and compliance generally.

REGULATORY LANDSCAPE IN AUSTRALIA

In Australia there is a mixture of general law and statutory legislation supplemented by regulatory guidance that regulates conflicts of interest in the financial services sector. The regulation of conflicts of interest is taken very seriously in Australia and the *Citigroup* litigation demonstrated the preparedness of ASIC to pursue perceived conflicts management failures through the courts and in the earlier enforceable undertaking obtained from AMP Ltd, failure to manage conflicts featured prominently in ASIC's findings.

However, the mixture of general law and legislative regulation makes it difficult for licensees to determine whether they have adequately discharged their obligation to manage conflicts properly. If a licensee has managed their conflicts properly in accordance with the legislation does this mean they have discharged their general law duty and vice versa. This issue has also been commented upon by the Chairman of ASIC, Tony D'Aloisio, in a speech to the Financial Planning Association last year. [1]

GENERAL LAW OBLIGATIONS

The need to manage conflicts of interest at general law is predicated on a licensee owing a fiduciary obligation to its client[2]. If a licensee is a fiduciary then it is clear

[1] Tony D'Aloisio, "*Regulating Financial Advice – Current Opportunities and Challenges*" Address to FPA Conference, 28 November 2007, at p.17
[2] C Band, *Conflicts of Interest in Financial Services and Markets* [2006] J.I.B.L.R. 677

from Lord Herschell's speech in *Bray v Ford* [1896] A.C. 44 at 51-52 as to a fiduciary's obligation:

> 'It is an inflexible rule of the Court of Equity that a person in a fiduciary position…. is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict…. [There] is danger in such circumstances, of the person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those he was bound to protect.'

The obligation of a fiduciary is to avoid conflicts of interest unless there is informed consent. Licensees could on occasions be characterised as acting as a fiduciary. This could arise in accepted fiduciary relationships such as principal and agent as might exist in certain circumstances between a stockbroker and his client. It could also arise in a trustee/beneficiary scenario as would exist with a responsible entity of a managed investment scheme, a trustee of a superannuation fund or with a custodian of securities.

Outside of the accepted relationships of fiduciary, it is still possible for a relationship to be fiduciary in character. In *Hospital Products Limited v United States Surgical Corporation* (1984) 156 CLR 41, Mason J held (at 96-97) that a critical factor in determining whether a person was a fiduciary was if the person:

> 'undertakes or agrees to act for on behalf of or in the interests of another person in the exercise of a power or discretion which will affect the interests of the other person in a legal or practical sense. The relationship between the parties is therefore one that gives the fiduciary a special opportunity to exercise the power or discretion to the detriment of that other person who is accordingly vulnerable to abuse by the fiduciary of his position.'

The approach taken by Mason J identified a number of factors to be taken onto account by a court as indicative of the existence of a fiduciary relationship[3]. Another approach taken is to use analogous reasoning from the decided cases and existing categories of fiduciary relationship to determine if in a given fact pattern a fiduciary relationship can be found to exist. This approach has been taken by one author[4] to argue that investment banks are in a fiduciary relationship with their clients when acting in a financial advisory role. In reaching this conclusion reliance is placed on analogous situations to be drawn from cases concerning stockbrokers and their clients, bankers and customers and corporate advisers and their clients. It is possible that such an argument could be raised in the context of a financial planner and his/her client.

---

[3] R P Meagher, J D Heydon and M J Leeming, *Meagher, Gummow and Lehane's Equity Doctrines and Remedies* (4th edition), Butterworths, 2002, p 157ff .

[4] A Tuch, *Investment banks as fiduciaries: implications for conflicts of interest* (2005) 29 MULR 15 (**Tuch 2005**) and A Tuch, *Obligations of financial advisers in change-of-control transactions: Fiduciary and other questions* (2006) 24 C&SLJ 488 (**Tuch 2006**)

Characterising the relationship between a licensee and its client as a fiduciary one is often readily made[5] when arguably it should not be so. The relationship between a licensee and its client normally arises in a commercial context where it might be reasonable for clients to expect and understand that licensees 'are seeking to promote the sale of financial products or financial services and to expect honesty rather than a lack of self-interest in that context'[6]. The courts have been reluctant to impose a fiduciary relationship where the parties are in a commercial relationship and dealing on an arms' length basis[7]. It is argued by advisers to the financial services industry that outside the accepted categories of a fiduciary relationship, financial services licensees are, generally speaking, not fiduciaries. Rather the relationship is one based on contract alone and that duties arise as part of the contractual relationship as well as under statute[8]. It is submitted that this analysis may not be correct. It is possible that fiduciary duties can co-exist with contractual duties[9]. The reasons for not wanting to characterise a licensee's relationship with its client as fiduciary are many. A fiduciary assumes many onerous duties such as the need to avoid conflicts of interest, a duty not to profit from its position as fiduciary at the expense of its customer/beneficiary, a duty of undivided loyalty and a duty of confidentiality. Failure to observe its duties may expose the fiduciary to 'equity's gain-stripping remedies'[10] such as an account of profits or a constructive trust.

The courts have nevertheless held that a fiduciary relationship can arise in the context of a licensee and its client in circumstances other than the usual categories of fiduciary. The leading Australian authority is *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371 (**Daly**). In that case, an investor sought advice from a stockbroking firm about potential investments. The broker advised the investor to deposit funds with the firm until such time as the stock market conditions improved to make investments. What the broker failed to disclose was the parlous state of the financial affairs of the broking firm that subsequently went into liquidation. The investor sought compensation from the stock exchange's fidelity fund on the basis of a breach of fiduciary duty by the stockbroking firm. The claim was unsuccessful as the money was not received in the manner required by the legislation to satisfy a claim under the fidelity fund. However, the High Court did give consideration as to

[5] See: Financial Planning Association, *FPA proposes Principles for managing conflicts of interest*, Media Release 28 April 2005, quoting the then chief executive of the FPA as saying: 'This restatement of every financial planner's fiduciary duty is the touchstone for all dealings with clients'; Lori A. Richards, *Fiduciary Duty: Return to First Principles*, Speech to the Eighth Annual Investment Adviser Compliance Summit, 27 February 2006, found at www.sec.gov/news/speech/spch022706lar.htm where she says on page 1 'all advisory firms, whatever their size, type or history in the business, owe their advisory clients a fiduciary duty.'

[6] R Baxt, A.J Black & P.F Hanrahan, *Securities and Financial Services Law* (6th edition) Lexis Nexis Butterworths, 2003, [1304]. See also: C Band above n 2 at p678 where she says '[the] fiduciary element is often missing because… the parties recognise that each is acting in its own interests and not trusting the other to look after theirs.'

[7] See: *Hospital Products Limited v United States Surgical Corporation* (1984) 156 CLR 41(**Hospital Products**) at 119 per Wilson J and at 149 per Dawson J

[8] Michael Vrisakis, *Two (un)sound bytes?* Financial Services Newsletter, Vol. 5 Nos. 6 & 7, Lexis Nexis Butterworths, pp 80 - 81

[9] See: *Hospital Products* at 97 per Mason J, *Kelly v Cooper* [1993] A.C. 205 at 215 per the Board citing Mason J in *Hospital Products* with approval and *Henderson v Merrett Syndicates Ltd* [1995] 2 A.C. 145 at 206 per Lord Browne – Wilkinson who said 'The existence of a contract does not exclude the co-existence of concurrent fiduciary duties'

[10] Tuch 2005, p479

whether a stockbroker could be regarded as a fiduciary. Gibbs CJ held [11] that the stockbroking firm owed a fiduciary duty and acted in breach of that duty.

Justice Brennan held:

> 'Whenever a stockbroker or other person who holds himself out as having expertise in advising on investments is approached for advice on investments and undertakes to give it, in giving that advice the adviser stands in a fiduciary relationship to the person whom he advises.'[12]

Having established that the stockbroking firm was in a fiduciary relationship with its client, Brennan J went on to state:

> 'The adviser cannot assume a position where his self-interest might conflict with the honest and impartial giving of advice….The duty of an investment adviser who is approached by a client for advice and undertakes to give it, and who proposes to offer the client an investment in which the adviser has a financial interest is a heavy one. His duty is to furnish the client with all relevant knowledge which the adviser possesses, concealing nothing that might reasonably be regarded as relevant to the making of the investment decision including the identity of the buyer or seller of the investment when that identity is relevant, to give the best advice which the adviser could give if he did not have but a third party did have a financial interest in the investment to be offered, to reveal fully the adviser's financial interest, and to obtain the for the client the best terms which the client would obtain from a third party if the adviser were to exercise due diligence on behalf of his client in such a transaction.'[13]

The decision in *Daly* has been followed subsequently in Australia by courts, which have held that a fiduciary duty exists in various situations involving financial services providers[14].

In *Aequitas*, Austin J in a very detailed judgment considered the dictum of Brennan J in *Daly* in the light of subsequent High Court decisions, most notably *Breen v Williams* (1996) 186 CLR 71. His Honour held that 'Brennan J's dictum should be taken to refer, for the most part, to the contractual aspects of the adviser-client relationship. The duty to provide 'best advice' and to disclose knowledge and information arise out of the adviser's 'undertaking', and are therefore implied terms of the contractual retainer'[15]. His Honour's analysis suggests that the terms are implied by law rather than by fact. That being the case, these terms will be implied into every contract where a fiduciary relationship exists between an adviser and its

[11] *Daly* at 377
[12] *Daly* at 385
[13] *Daly* at 385
[14] *Commonwealth Bank of Australia v Smith* (1991) 42 FCR 390 (banker and customer) but contra *Commonwealth Bank of Australia v Finding* [2001] 1 Qd R 168; *Aequitas Limited v Sparad No. 100 Ltd* (2001) 19 ACLC 1,006 (**Aequitas**) (corporate adviser and client)
[15] *Aequitas* at [287]

client[16]. Terms implied by law must be consistent with the express terms of the contract otherwise they will not be implied[17].

Whilst it is clearly possible to characterise a relationship between a licensee and its client as fiduciary, it should not be assumed that a given relationship would always give rise to a fiduciary relationship[18]. It is necessary to examine the ambit of the licensee's retainer to determine what duties have been accepted by the licensee and nature of the relationship between the licensee and the client[19]. Where there is more reliance by the client on the licensee or more discretion is reposed in the licensee to determine matters for the client, the more likely a fiduciary relationship will be found to exist.

The relationship between a financial planner and client does not fall into the class of recognised fiduciary relationships so much will depend on an examination of the facts and contractual arrangements between the planner and the client. A fiduciary relationship could arise in circumstances where personal advice or general financial advice is provided. Further, if the planner has other powers or discretions such as making investments on behalf of clients or acts as trustee of a client's discretionary trust, fiduciary duties are likely to arise.

CONTRACTUAL TECHNIQUES

As a result of the *Citigroup* case, opportunities arise to restrict or eliminate any fiduciary duty. Jacobson J held "it is open for parties to a contract to exclude or modify the operation of fiduciary duties."[20] Clearly, in a case such as *Citigroup* where there are sophisticated parties who are well advised, this is clearly possible.

It is suggested that with a financial planner such fiduciary duties can be excluded with "informed consent".[21] It is submitted that this may not be the case. Informed consent is only required where a fiduciary relationship already exists and the fiduciary needs informed consent in order to have a conflict of interest. However, contracting out of a fiduciary relationship only requires clear words that give effect to that desire.

If a fiduciary relationship is not excluded, consideration needs to be given as to the ambit of that duty in the context of a financial planner giving advice. Under s945A of the *Corporations Act* a planner is required to provide advice that is appropriate for the client. However, the general law duty is to provide 'best advice' so it is necessary for the planner's retainer to be clear as to what duties are being assumed if the planner is not be caught by Brennan J's dictum in *Daly*.

[16] J. W. Carter, *Carter on Contract*, (2 vols) Lexis Nexis, 2002, Vol.1 at [11-120]
[17] J.W. Carter, above n14, Vol 1 at [11-160]
[18] As is suggested in Tuch 2005 and Tuch 2006 with respect to investment banks acting as corporate advisers
[19] Baxt et al, above n6, [1304]
[20] *ASIC v Citigroup Global Markets Australia Pty Limited*(2007) 25 ACLC 940 at 969
[21] Tony D'Aloisio, above n 1, at p17

PRE SECTION 912A (1) (aa) LANDSCAPE

Prior to the enactment of section 912A (1) (aa) of the *Corporations Act*, various statutory obligations required licensees to manage conflicts. In part, the need to manage conflicts of interest is covered by the licensee's obligation to provide financial services 'efficiently, honestly and fairly' within the meaning of s912A (1) (a) of the *Corporations Act*. ASIC sets out what it expects of licensees in this regard in Regulatory Guidance 164. At [RG 164.138A] ASIC states that it requires related party issues be dealt with so as to manage conflicts of interest. However, it is submitted that s912A (1) (a) is probably not sufficient to ensure that conflicts will be managed properly. In one case[22] dealing with the former legislation, the Administrative Appeals Tribunal found that a significant failure to disclose a conflict of interest was insufficient to support a finding that a licensee failed to act 'efficiently, honestly and fairly'. Further, as was pointed out in the explanatory memorandum when introducing s912A (1) (aa), '[while] industry has noted that [s912A (1) (a)] would include managing conflicts of interest, the duty was not express in its application to conflicts of interest'[23].

There are numerous other provisions in the *Corporations Act* dealing with conflicts of interest with respect to retail clients[24]. The method of dealing with conflicts or potential conflicts in each case is by disclosure. Whenever a licensee is to provide a financial service to a retail client, it must provide a financial services guide (**FSG**): s941A. Section 942B of the Corporations Act provides in part that a FSG must include statements and information about remuneration to be received by the providing entity, any related body corporate of the providing entity, any director or employee of the providing entity or its related bodies corporate and any associate of any of them. The section also requires that a FSG include statements and information 'about any associations or relationships between the providing entity, or any related body corporate, and the issuers of any financial products, being associations or relationships that might reasonably be expected to be capable of influencing the providing entity in providing any of the authorised services'[25]. Whilst these sorts of provisions can be characterised as dealing with pricing and transaction transparency so that clients can understand the true cost of the product or service they may be purchasing, they also deal with conflicts management issues.

Similarly with statements of advice (**SoA**), specific obligations exist in s947B of the *Corporations Act*. The requirement to give a SoA arises where there is the provision of personal advice and the person to whom it is provided is a retail client: s944A and s946A (1). Section 947B sets out the main requirements for a SoA. A similar provision exists where an authorised representative issues a SoA[26]. Section 947B has its origins in the former section 849 of the *Corporations Act*. That section was concerned with securities recommendations and was not restricted to the retail situation. More importantly, there was an information barrier defence available under

---

[22] *Re Saxby Bridge Financial Planning Pty Ltd and Ors and Australian Securities and Investments Commission* [2003] AATA 480 at [309] – [310]

[23] Commonwealth Parliament, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 Explanatory Memorandum* (**Explanatory Memorandum**) Para. 5.595

[24] See definition of 'retail client' in s761G

[25] See s942B (2) (f) of the *Corporations Act* and regulations 7.7.04 and 7.7.04A.

[26] See s 947C (2) (e) and (f)

the former section 850 for a breach of the equivalent provisions of section 947B (2) (d) and (e) which is not available for a breach of section 947B. It is unclear why no such defence is allowed as it is arguable that information held behind a Chinese wall would not necessarily influence advice given to a client[27]. Whilst it may be justifiable to deny such a defence to a small financial services body where it would be difficult to erect meaningful information barriers, it is problematic for large financial services organisations, such organisations may seek to negotiate commercially sensitive arrangements with product issuers which would not influence the advice their employees or authorised representatives may give clients if they are unaware of the arrangements. In retail financial services, it is just as possible for a large conglomerate to organise efficient and effective information barriers as is it is for an investment bank operating in the wholesale markets.

ENACTMENT OF SECTION 912A (1) (aa)

In 2002, governments and financial regulators around the world became increasingly concerned about conflicts of interest in investment banking. This stemmed initially from investigations conducted by the New York attorney general's office into research practices carried out at the investment bank, Merrill Lynch. The investigation revealed that research was 'tainted and biased by the desire to aid Merrill Lynch's investment banking business…. [that resulted in the firm disseminating]… misleading information that helped its corporate clients but harmed individual investors'[28]. This investigation was followed by a joint investigation by the Securities and Exchange Commission, the New York attorney general, the National Association of Securities Dealers, Inc. (**NASD**) and others in 2002 that led to a US$1.4 billion settlement with ten major investment banks to resolve issues of conflicts of interest in investment banking research and other areas[29].

In Australia, the federal government responded as part of its corporate law economic reform program, commonly referred to as 'CLERP'[30]. In the series of proposals known as 'CLERP 9'[31], the federal government enacted s912A (1) (aa) of the *Corporations Act*. After considering various options, the government determined that having a specific licensing obligation to manage conflicts of interest, which was supplemented by ASIC guidance, was the best solution. It was also noted that industry supported a principles based approach to regulation[32]. To this end parliament enacted section 912 A (1) (aa) which provides that licensees must:

[27] Baxt et al, above n6,[1326]
[28] Office of the New York State Attorney General Eliot Spitzer, 'Merrill Lynch stock rating system found biased by undisclosed conflicts of interest' Press Release 8 April 2002 found at www.oag.state.ny.us/press/2002/apr/apr08b_02.html
[29] Office of the New York State Attorney General Eliot Spitzer, '$1.4 Billion Global Settlement Includes Penalties and Funds For Investors' Press Release 20 December 2002 found at www.oag.state.ny.us/press/2002/dec/dec20b_02.html
[30] The federal government conceded it was responding to the overseas experience in its commentary that accompanied exposure draft of the bill which introduced s912A (1) (aa): see *CLERP (Audit Reform and Corporate Disclosure) Bill* Commentary on the draft provisions ,October 2003, (**CLERP 9 Commentary Paper**) p143
[31] *Corporate Law Economic Reform Program (Audit and Corporate Disclosure) Act 2004* (Cth)
[32] Explanatory Memorandum, [4.166]

> 'have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business of the licensee or the representative'

The Explanatory Memorandum highlighted the types of conflicts that the section was meant to cover. First, licensees must manage conflicts within the financial services business which would cover 'conflicts [arising] within one area of the financial services business … or across different areas of the business'[33]. Second, licensees also need to manage conflicts that arise between something within the financial services business and something outside the financial services business. Excluded from the statutory regulation were conflicts that arose entirely outside the financial services business although it was acknowledged that there may be other obligations to manage such conflicts[34].

Another significant point to note is that parliament required that licensees have in place arrangements for the 'management of conflicts of interest' rather than requiring licensees to avoid conflicts of interest. This ensured that financial conglomerates such as investment banks or large commercial banks with wealth management businesses would not need to disaggregate. The federal government recognised that financial conglomerates provide benefits to consumers in its commentary on the exposure draft of the bill[35]. Whilst the obligation to manage rather than avoid conflicts would be welcomed by industry, it is at odds with some of the other provisions highlighted above. Because of the obligation to disclose in FSGs and SoAs when dealing with retail clients, some financial services organisations are unable to avail themselves of other avenues for conflicts management. Therefore, there should be a reinstatement of the defences that existed in the former section 850 of the *Corporations Act.* This would bring consistency across the board to conflicts management in both the wholesale and retail sectors where comparable services are being provided.

CONCLUSION

The regulation of conflicts of interest in the Australian financial services industry does not provide a unifying principle that can guide industry clearly. By not being clear on the overall thrust on managing conflicts, it makes for a complex compliance regime that must increase the cost to industry in delivering financial products and services.

The enactment of s912A (1) (aa) is a necessary reform but it is somewhat limiting due to the scope of Chapter 7 of the *Corporations Act.* Further consideration of Chapter 7 needs to be given to bring the various conflicts management sections into alignment with the overall obligation placed on licensees in s912A (1) (aa).

The fact that a financial planner can be regarded as a fiduciary only makes matters more difficult. The issues that have been highlighted in respect of financial planners

[33] Explanatory Memorandum, [5.599]
[34] Explanatory Memorandum, [5.600]
[35] CLERP 9 Commentary Paper, [580]

are not unique. These issues could apply equally to other advisers in financial services.