



Securities Trading by Investment Bank Advising on Takeover: Is It Insider Trading?

In a recent decision, *ASIC v Citigroup Global Markets Australia Pty Limited (2007)*, the Federal Court of Australia was asked to decide whether an investment bank that had been advising a client on its takeover of another company had breached its fiduciary duties to that client. It also had to consider whether there had been insider trading. Both allegations arose from the fact that the bank had continued to allow its public-side employees to trade in the shares of the target company during the run-up to the takeover. The case, while not binding on Singapore courts, provides a useful guide as to how local provisions on insider trading may be applied. This update looks at the case, and considers its implications.

Facts

Bank has investment banking and equities trading arms

In this case, the respondent is a financial services company based in Australia. Its business is divided into various departments, including investment banking and equities trading. Investment banking constitutes one of its “private-side” departments, so referred to because its employees are frequently privy to confidential, price-sensitive information. In contrast, the equities trading department is referred to as being “public-side” as its employees are not so exposed. To ensure non-exposure, the respondent instituted strict Chinese wall or information barrier procedures to prevent the flow of information from the private-side to the public-side employees.

While bank advised on takeover, trader purchased target's shares

At the relevant time, the respondent's investment banking arm was advising Toll Holdings Ltd (“Toll”) on a proposed takeover of Patrick Corporation Limited (“Patrick”). The market was awash with rumours that such a takeover was imminent. During this period, a trader in the respondent's equities trading arm purchased substantial amounts of shares in Patrick.

When a senior manager at the investment banking department realised that this was happening, he called his homologue at the

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equities trading department. He referred to the recent purchases of shares in Patrick and stated, "We may have a problem." Nothing more was stated, and the senior manager at the equities trading department refrained from asking further (He acknowledged during the trial that he did so because knowing more could have compromised his position).

Trader told not to purchase any more shares in target

The equities trading senior manager then called the trader who had purchased the shares in Patrick, and asked him to meet outside for a cigarette. During their short chat, the senior manager asked him why he was buying shares in Patrick. The trader replied that market rumours made it look like an attractive investment. The senior manager then said, "Don't buy any more." That was the end of the conversation. Later that afternoon, the trader sold off a substantial tranche of shares in Patrick (although he made no further purchases).

Allegations of conflict of interests and insider trading

Based on these facts, the applicant, the Australian Securities and Investments Commission, brought proceedings against the respondent, alleging that:

- the respondent's relationship with Toll was as a fiduciary and, hence, allowing proprietary trading in Patrick's shares without obtaining Toll's informed consent to the same was a breach of its duties as a fiduciary; and
- the trader's actions amounted to insider trading on the part of the respondent.

The Federal Court of Australia rejected both allegations, and its reasons are discussed more fully below.

No Fiduciary Relationship Between Respondent and Toll

Whether bank as adviser to takeover was a fiduciary

The applicant had argued that the respondent stood in a fiduciary relationship as against Toll. Fiduciaries, such as lawyers and directors, are required to act in their beneficiaries' best interests and, hence, are not permitted to put themselves in a position where their interests (among others) would be in conflict with that of their beneficiary. For lawyers, this means that they must act at all times in the best interests of their clients, and for directors, the company on

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whose board they sit.

However, directors and lawyers are among the classes of persons traditionally recognised at law as fiduciaries. Investment banks advising on takeovers have never fallen into this category. Other than these already fixed categories, the law may find that there is a fiduciary relationship where a person has undertaken to act in the interests of another, and not in his or her own interests. An adviser may, therefore, be a fiduciary where, as part of his engagement, he has undertaken to act in the best interests of his client. Stockbrokers, for example, are one such class of person.

*Fiduciary relationship
may be modified by
contract*

The Court accepted, however, that an adviser may by contract modify or exclude its fiduciary relationship with its client. The respondent's engagement letter had specifically provided that it was not entering into a fiduciary relationship with Toll. Accordingly, the Court held that it had successfully excluded any fiduciary obligations. There was hence no issue of conflict of interests.

No Insider Trading

The Court rejected the allegation that there was insider trading on the part of the respondent. This allegation was based on two grounds:

- that the trader had sold shares in Patrick while in possession of material price-sensitive information, and his knowledge should be attributed to the respondent; and
- that the trader had bought and sold shares in Patrick while the management of the investment banking arm were in possession of material price-sensitive information about the possible takeover, and their knowledge should be attributed to the respondent.

Knowledge in Possession of the Trader

*Trader not officer of
bank*

The Court held that the allegation based on the knowledge of the trader failed on two grounds. The first was that the trader was not an officer of the respondent as defined in the Australian Corporations Act, and hence his knowledge could not be attributed to it. For the purposes of Singapore law, this ground can be passed over rapidly

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as the Australian definition of "officer" is not the same as the Singapore definition, and the case would therefore not apply here in that limited respect.

Information may include suppositions of fact

The more interesting decision of the Court with respect to the knowledge of the trader was that the applicant had not shown that the trader had the necessary knowledge for the purposes of the insider trading provisions. The applicant made the rather limited allegation that the information in the hands of the trader was the supposition that the respondent was acting for Toll in the proposed takeover of Patrick. The Court accepted that such a conjecture could amount to information for the purposes of the insider trading provisions. In this respect, the Court noted that what constitutes "information" is very wide, and would include situations where the tippee drew inferences from innocent statements made by an insider.

Trader did not infer that bank was acting for bidder

However, the claim failed because the applicant had only shown that, from the trader's conversation with the senior manager of the equities trading department, he had at best inferred that the respondent might be involved in some way with the possible takeover of Patrick. This, however, was not the same as the more specific supposition that the respondent was acting for Toll in the takeover.

At time of talk, information no longer price sensitive

The claim also failed in a further respect. The Court held that at the time the trader sold off shares in Patrick, the market price of Patrick's shares already reflected the possibility of a takeover. The information as to the respondent acting in respect of a takeover of Patrick was by then, therefore, no longer price-sensitive information.

Knowledge in Possession of the Management of the Investment Banking Arm

Whether reasonable information barriers in place

The Court also rejected the allegation of insider trading based on the knowledge of the senior management at the investment banking arm. It noted that while the senior management knew of the proposed takeover bid of Patrick by Toll, the respondent had put in place arrangements that could reasonably be expected to ensure that the information was not communicated to the public-side employees.

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In this respect, it is useful to note that while the applicant argued that the actions of the senior managers of the investment banking and equities trading departments went outside what was set out in the respondent's written procedures on Chinese walls, this did not mean that there were no arrangements in place. It simply meant that as a practical measure, it was impossible to ensure that every conceivable risk was covered by written procedures and followed by employees.

*Such barriers
sufficient if they meet
reasonable standards*

However, this was not the standard imposed by the insider trading provisions. These provisions set an objective standard: that of reasonable expectation. The general procedures that were set out did meet that standard, and hence, the Chinese wall requirements set by the legislation were met.

Significance and Implications of Case

Singapore's provisions on insider trading are contained in the Securities and Futures Act, and are based on the Australian provisions. Accordingly, this decision of the Federal Court of Australia provides a useful indication as to how our own provisions may be construed by the local courts.

Fiduciary Relationship Can Still Be Found to Exist

*ASIC's case turned
on scope of
engagement letter*

While the Court's decision that an investment bank may by contract exclude a fiduciary relationship with its client, it must be noted that the applicant's case on this issue was based on whether the terms of engagement gave rise to such a fiduciary relationship. It expressly did not rely on an argument that a fiduciary relationship had arisen earlier. This is important because the Court indicated that it would have been minded to take the view that such a relationship had arguably arisen by the time the engagement letter was signed. The Court was less sure that, if this had been the case, the engagement letter could then annul a pre-existing fiduciary relationship.

*Fiduciary
relationships may*

Accordingly, the point remains open for argument, and the decision should not be seen as sanctioning the efficacy of clauses excluding

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hence still apply

fiduciary relationships in all circumstances. From a practical perspective, therefore, this means that banks will need to carefully consider whether, to deal with the legal risk arising from this issue, they may wish to extract from their clients their specific informed consent to trading by their proprietary arms.

Insider Trading in Similar Circumstances Remains a Real Risk

ASIC's case turned on specific supposition alleged

The other issue of concern arises from the Court's decision on insider trading. To some extent, the decision turned on a technicality. The applicant had framed its claim very narrowly by specifically stating that the relevant supposition was the inference that the respondent was advising in the takeover of Patrick. This very specific inference had not been made out on the facts of this case.

Because the result was highly fact-sensitive, a slight change in the factual matrix could have led to a different result. The risk of a court finding a charge of insider trading to have been made out on similar facts is therefore not unlikely.

Some comfort, however, may be derived from the Court's ruling that Chinese walls need not cover every possible eventuality—or the eventuality that actually occurred—for the statutory Chinese wall requirements to have been met.

If you would like information on this or any other area relating to mergers & acquisitions, you may wish to contact the lawyer at WongPartnership that you normally deal with or contact the following partners from the Corporate/Mergers & Acquisitions Practice:



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