Managing Conflict: ASIC v Citigroup and the Implications for Regulatory Enforcement

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ABSTRACT

The debate over how to control the corporate form remains as vital as when the systemic problem associated with the separation of ownership from control was first articulated seventy-five years ago. Resolution and, therefore, progress is difficult, if not impossible, within the self-referential and closed terms adopted in much of the corporate governance literature and public policy debate. The paper assesses the normative and empirical utility of accounts that do not take into consideration how externalities influence function, scope and efficacy of corporate governance regimes. Without reference to an ethical underpinning, strengthening mandatory rules or enabling principles in response to scandal can be seen, ultimately, as an unrewarding exercise of Sisyphean proportions. Second, it extends this analysis to the governance of the wider market, with particular reference to the management of conflicts of interest. Third, it explores the crystallization of these issues in *Australian Securities and Investments Commission (ASIC) v Citigroup Capital Markets*. The central argument advanced here is that absent fundamental agreement on what constitutes 'compliance' ongoing regulatory capacity to leverage change in either corporate or wider market governance could prove short-lived.

INTRODUCTION

Effective management of legally permissible conflicts of interest at corporate level requires, in the first instance, self-regulating commitment to generic core values. These are given tangible expression in codes of conduct. They are designed to increase awareness, articulate what constitutes prohibited conduct and enunciate expected behavioural standards. The codes are enveloped within a legal and regulatory framework that embodies - with differential specificity - ethical principles. These include, for example, general criminal laws prohibiting theft or fraud and, more nebulously, regulatory rules designed to uphold market integrity. The recent rash of financial reporting scandal and other manifestations of misfeasance highlighted profound deficiencies with this model. It also changed temporarily the dynamics of capital market governance.

This global transformation could be witnessed across two interlinked dimensions. First, *policy* imperatives privileged ever more prescriptive modes of corporate governance. To restore confidence, responsibility was redefined to include (again) an explicit ethical dimension. In particular, corporate governance was conceived as the concrete manifestation of the 'corporate conscience' (Glassman, 2002). It was a refrain first rehearsed in the 1930s, restaged in the 1970s in the aftermath of Watergate (and unrelated corporate collapses) and revived in the 1990s (e.g. Berle, 1931; Dodd, 1932; Mason, 1959; Manne, 1962a; Hessen, 1979; Baldwin, 1984; Harris and Kramer, 2002). Second, the process of implementation necessarily extended application beyond the corporation, partially reconfiguring the role of gatekeepers and, more significantly, the relationship between legal subfields. The integration punctures their self-referential basis by vacating foundational

jurisprudential certainties. This shift has enormous potential implications for how we conceptualise the duties and responsibilities of the corporation.

The implications of the collision between public and private discourses have prompted extensive theoretical reflection in contract law (e.g. Ayres 2003; Posner 2003). The process has been characterized as the 'productive disintegration of private law' (Collins, 1999: 53). Collins point is not that that private law has lost vitality. Indeed, he goes as far as to suggest that it 'is the index finger of the invisible hand that guides the markets' (p. 59). Rather, continued relevance in the face of regulatory imperatives requires interdiction with changed realities about how standards, monitoring and enforcement can, or should, be best applied. For Collins, this requires, for example, better procedural access and the introduction of externality considerations to specific court determinations, such as treating individual litigants as representatives of a wider class of potential plaintiffs. This level of theoretical sophistication is largely lacking in much corporate governance research, which tends on concentrate on form not normative function. Even when accountability is discussed, it tends to take formal legalistic form that accepts the contingent parameters set by prevailing structures. Alternatively, when communitarian approaches are privileged there is little attempt to enter a sustained dialogue with contractual proponents (see Wheeler, 2002: 5-6). As a consequence, the discipline is not well placed to provide either a predictive or normative account of compliance failure.

The renewed interest of political scientists in corporate governance partially addresses the deficiency by mapping the contingent basis of regulatory power (e.g. Gourevitch and Shinn 2005). Goerevitch and Shinn state explicitly, however, that they have not calibrated the complex and fragmented interests of financial intermediaries, a

situation they describe as an empirical ‘black box’ (p. 287). The ‘plasticity of preferences’ (p. 287) is another acknowledged limitation. While undoubtedly correct in highlighting the critical importance malleability plays in influencing public and corporate perceptions of the legitimacy of corporate governance reform, the analytical agenda suggested by Gourevitch and Shinn remains locked into narrow ‘realist’ conceptions of corporate responsibility. Less attention is placed on whether, and, if so, how, to transcend the demonstrable failings associated with legalistic conceptions of corporate ethics, accountability and compliance.

The extent to which specific corporate governance and wider regulatory policy reform agendas should reflect an explicit ethical dimension is, of course, exceptionally contested. There is a profound lack of agreement on what constitutes unethical or harmful corporate practices or legal defences (e.g. Arshadi and Eyssell, 1993; Manne, 1962b). Adopting ‘perfectly-legal’ strategies to transact around compliance obligations, for example, can be justified by reference to the corporate imperative to maximise profits within the letter of the law or as Friedman (1970) put it famously, ‘within the rules of the game’. Later variations of this approach suggest that enhancing the legal position of interest groups other than shareholders magnifies problems of control by introducing multiple principals (e.g. Easterbrook and Fischel, 1991). Indeed, for many years the *ultra vires* doctrine of company law effectively mandated such an approach.[1] Likewise, the requirements that lawyers act as officers of the court could be deflected by a diametrically opposed reliance on fiduciary duty to justify professional obligation to serve the client. Using claims of privilege to thwart regulatory investigations is not only prevalent, for example, it is arguably an integral component of successful practice in the gladiatorial environment of adversarial legal method (Carver, 2005; Kaplan, 2003; McBarnet, 2006).

The situation takes on an exponentially more complex form when the matters under consideration constitute misfeasance i.e. ethically questionable conduct that is not specifically proscribed. If new standards are to be introduced what should the benchmark be? Who should set it? When core values conflict, which should be privileged and why? Should interpretation of (non-) compliance and censure rest with the corporation itself (through shareholder activism), the market (with disclosure impacting on share value) the regulator (through enforcement strategies, which seek to transcend the existing legal core by mandating particular governance forms) or wider society (through a reinterpretation of the core responsibilities owed by the firm in return for the benefits of incorporation)? If the later can this be done in a piecemeal manner? Alternatively, does it require a more fundamental reconstruction, a re-imagining, as it were, of the corporation and its societal purpose? If so how could the new account be constructed, what forces require marshalling (or stymieing) and to what extent can the process retain the theoretical underpinnings of private law?

The introduction of more stringent controls relating to the management of conflicts of interest in Australia illuminates the implications of global imperatives on both *policy* formulation and the *process* of implementation. In common with other developed capital market jurisdictions, Australian policymakers are seeking a much more modest goal than conflict eradication (ASIC, 2006). The focus is ostensibly limited to three core aims: (1) re-articulating broad principles; (2) clarifying the underlying rationale governing compliance and enforcement priorities; and (3) privileging prophylactic surveillance strategies to uphold market integrity. This is, in itself, unproblematic. Indeed, the corporate regulation literature suggests legal certainty combined with the availability of effective protection measures for minority shareholders can be a key determinant for capital market growth (e.g. La Porta,

Lopez-de-Silanes, Shleifer and Vishny, 1998).[2] Controversy centres, rather, on how these rules are set and enforced. Contestation extends from problem definition through regulatory design to implementation. This opens the space for legitimate questioning over the accountability standards industry – and wider society – can expect from the peak financial regulator. Mapping how ideational disputes directly influence the trajectory of public policy allows for a consideration of whether it is possible to instil order under the current system of control or whether, as with Sisyphus, we are caught in a laborious yet futile struggle.

The paper first explores the foundational premises of corporate governance theory. It assesses the normative and empirical utility of concentrating on internal mechanisms without consideration of how externalities influence function, scope and efficacy. Second, it extends this analysis to the governance of the wider market, with particular reference to structural mechanisms designed to uphold market integrity, including the management of conflicts of interest. Third, it explores the crystallization of these issues in *Australian Securities and Investments Commission (ASIC) v Citigroup Capital Markets,* sentinel litigation now before the Federal Court. The statement of claim accuses the bank of insider trading and bringing the market into disrepute by engaging in unconscionable conduct. The paper tracks the impact of the litigation and its timing on the dynamics of the domestic and wider global policy debate. It provides evidence that the ideational battleground has shifted globally. Crucially, the media emphasis no longer remains on the underlying problem. Rather it centres on a powerful counter-attack that questions regulatory legitimacy and the implications of reform for legal coherence and market efficiency. While muscularity may seem superficially attractive, particularly in responsive mode, it can lead regulators into a 'compliance trap' (Parker, 2006). The central argument advanced

here is that absent fundamental agreement on what constitutes 'compliance' ongoing regulatory capacity to leverage change in either corporate or wider market governance could prove short-lived.

1. The Modern Corporation and the Myth of Sisyphus

The debate over how to control the corporate form remains as vital as when the systemic problem associated with the separation of ownership from control was first articulated seventy-five years ago (Berle and Means, 1932). Resolution and, therefore, progress is difficult, if not impossible, within the self-referential terms adopted by much of the corporate governance literature and public policy debate. This approach, based on an acceptance of primarily industry-designed principles of best practice, is reactive in nature and largely piecemeal (e.g. Cadbury, 1992; Pettet, 2005: 196-211). Instead we are caught in a recidivistic cycle: Scandal leads to reform; gradual dissipation of public unease weakens the traction necessary to retain regulatory authority; exercise of excessive discretion helps to transform the ideational discourse; how to resolve the underlying problem is displaced by (real) concern about regulatory overreach; judicial criticism provides validation (of abuse); and (in the US at least), depending on the stage of the electoral cycle, campaign-funding imperatives begin to dominate. The controversy over the creation and reframing of the New Deal securities architecture - for which *The Modern Corporation and Private Property* (1932) provided crucial ideological support - was the paradigmatic example. On the evidence to date, Sarbanes-Oxley and its global analogues could well face a similar fate (e.g. Langevoort, 2006; O'Brien, 2007; Roe, 2005).

The concept of fate raises interesting questions for both the corporate governance academic and the compliance professional. Notwithstanding enormous

practical advances in the institutional design of compliance programs, the processes remain susceptible to managerial override. In large part this can be traced to function. The normative capacity of compliance to embed cultural change is emasculated if compliance is perceived to be little more than a necessary response to (unwarranted) external restraints (e.g. Rossouw and van Vuuren, 2003). This emasculation is exacerbated if the wider corporate governance agenda lacks the empirical strength to anchor legitimacy. Crucial issues relating to (and generally discounting the material value of) principles of corporate governance best-practice or mandatory rules have been subjected to rigorous and, at time, vituperative analysis. Critics suggest there is little or no evidence that separating audit and consultancy function impairs audit quality; that the proportion of independent directors is immaterial to board performance; that violations of best-practice principles do not, in fact, attract market discounting unless accompanied by a decline in economic performance (e.g. Romano, 2005). The wisdom (or otherwise) of strengthening mandatory rules or enabling principles in response to scandal can be seen, ultimately, as an unrewarding exercise of Sisyphean proportions. The strength of the Sisyphus myth rests precisely on the fact that for a short period of time order is restored: reform is either introduced or repealed. It is the ephemeral nature of this order that constitutes the absurdity of the task, as Albert Camus reminds us:

> That hour like a breathing-space which returns as surely as his suffering, that is the hour of consciousness. At each of those moments when he leaves the heights and gradually sinks toward the lairs of the gods, he is superior to his fate. He is stronger than his rock. If this myth is tragic, that is because its hero is conscious. Where would his torture be, indeed, if at every step the hope of succeeding upheld him? The workman of today works every day in his life at the same tasks, and this fate is no less absurd. But it is tragic only at the rare moments when it becomes conscious (Camus, 1975: 377).

This, of course, raises subversive and largely unanswered questions. What precisely is the point of continuing in this research vein? Is it possible to exercise control without reconstructing a new social contract; a process that requires a re-imagining of the corporation and its values? Does the interminable focus on internal process and accountability service to enhance or stymie that objective? Is the research agenda neutral (and therefore in Camus' terms merely absurd)? Or does it serve an implicit political agenda (and, therefore, is tragic for both the corporation and wider polity precisely because it deflects attention from the underlying problem)?

The point here is not to suggest that labouring to improve corporate governance systems is without value. Rather it is to highlight paradigmatic weaknesses in corporate governance theory that preordain failure. When normative considerations do come into play, they tend to challenge the right of the state to intervene in the governance of a private entity on negative grounds (e.g. Manne 1962a; Hasnas 2006a; 2006b; 2006c). This position not only threatens to undermine the notion of democratic sovereignty (e.g. Dahl, 1990: 96-107); it is arguably, an empirical reality owing to the capacity of corporate interests to distort the 'Schumpterian' political competition model through strategic campaign funding (e.g. Shapiro, 2003: 74-5). The democratic accountability deficit is displaced by the ideational emphasis on the shareholder, who exerts a 'sovereign' freedom to contract by entering 'as a right' into a free association (Hessen, 1979: 115). Private ownership rights are transferred to the firm, which is invested with a distinct, if artificial, legal personality. The normative emphasis remains on the 'legal personality' component rather than its 'artificiality'. When such an emaciated conception of contract theory is applied to corporate governance, the memorandum of association gives operational discretion to managers, with the courts limiting intervention to demonstrable

violations of internal control processes. Adjudication of the consequences of organizational culture and the impact this has on (un)ethical decision-making is left to the corporation itself to decide because of the reluctance of the courts to second-guess business decisions taken within legal parameters. This state of affairs is itself inextricably linked to what Stone (1975) famously termed as 'the paucity of imagination' governing company law.

The duties and responsibilities owed by the owners of the corporation are bypassed completely in dominant economic accounts. These characterize the corporation as merely a 'nexus-of-contracts' (Fama, 1980). Notwithstanding the legal certainty that contracts provide, their legitimacy as a control mechanism within corporate governance is inextricably linked to the power of the contractual metaphor. The narrative structure in contractual accounts utilizes 'synechoches' and 'metaphor' to make a normative leap from description to prescription (e.g. Stone, 2002: 137-62). The inherent ambiguity of symbols forms the political analogue of the economic 'invisible hand' (see Collins, 1999: 59). This facilitates suspension of critical thinking about the origins and implications of the social construction of the corporation. This move also, in practice, limits the focus of what constitutes an optimal balance between the right to self-governance and societal need for accountability to assessment of whether the contract is enforceable (Wheeler, 2002: 6). Counter-intuitively, privileging the contractual rights of the individual firm (through its rentier shareholders) renders control ineffective, precisely because the instrumental approach to ethics and accountability it preordains is not in the long-term interests of the corporation itself (Dahl, 1990:104; Ireland, 2000). Going back to Camus, within the corporate governance realm lucidity emerges at precisely the same time that control is reasserted (even if not empirically demonstrable); the tragedy is that instability is

inextricably linked to the maintenance of socially constructed, self-referential and closed categorical imperatives.

Effective compliance must take into account that fact that individual ethical choices are informed and restrained by overarching organizational culture, which in turn is framed by what is legally permissible (and/or politically justifiable). While it is a truism that commercial morality cannot be legislated for, it is possible to design regulatory policies that enhance the positive impact of intangible factors such as esteem through norm reinforcing compliance programmes (Brennan and Pettit, 2004: 249-66). The deployment of norms can be an effective mechanism to influence (and protect) the corporation from reputational risk. This is particularly the case when the relationship between stated aims and actual practice is dysfunctional, as demonstrated in the conflicts of interest investigations launched by the New York State Attorney General Eliot Spitzer (Cassidy, 2003). Spitzer's investigations and the corporate governance changes he introduced as a price for settlement suggested a profound (if contested) reformulation of how law and norms could be fused to navigate the complexity of daily practice. How to design such an approach will be explored more fully below, first it is necessary to demonstrate how defects of the current approach are magnified when the nexus of contracts approach is applied to the overarching governance of the market.

2. The Fiduciary Imperative and Structural Porosity of Conflicts Management

As with other areas of governance, the regulation of financial services is predicated on balancing conflicting imperatives. Regulators strive to facilitate liquidity, depth and innovation while minimising the material and reputation transaction costs associated with an incomplete or uncertain legal framework. A

critical component for longer-term growth is the projection and maintenance of probity. The complexity and volume of market operations create enormous oversight problems, which can only be addressed through the formal enrolment of financial intermediaries into the surveillance apparatus. This is, however, far from unproblematic. By facilitating access to both products and markets, they act as 'gatekeepers' to an inherently conflicted space.

As a restraining mechanism it can take 'hard' legislative form, such as Sarbanes-Oxley in the United States. Controls can also display the 'softer' characteristics associated with responsive modes of regulatory governance. Corporate-specific variations of industry best-practice guidelines can be given formal legal standing. The exact form can be further calibrated through listing and licensing requirements, which are subsequently policed, in part, or in whole, by the stock exchange. Depending on the jurisdiction these can be mandatory (as in the United States) or have an enabling basis (as in other key common law jurisdictions such as the United Kingdom and Australia) where variation from default principles is permitted if disclosed. Restraints can be further augmented by corporate endorsement of wider principles of professional conduct. Designed to signal a commitment to probity, violation can provide the basis for (rare) civil prosecution or (rarer) industry censure. This combination of internal and external controls forms the corporate governance paradigm, with business judgement, of necessity, remaining at the core.

The capacity of these communities of professionals to engage in self-dealing detrimental to the interests of individual clients or, by extension, the integrity of the wider market system, is central to the articulation of fiduciary obligation.[3] As Finn (1977: 1) makes clear, it is meaningless to talk of [generic] fiduciary relationships as such'. It requires the presence of the following interlocking determinants: the binding

(or perceived binding) obligation to act in the interests of another, without intermediating contractual provisions limiting the fiduciary's independence to act (pp. 9-13). Recent legislative changes in Australia severely weaken its efficacy as a restraining force. Structurally, the expansion of Incorporated Legal Practices (ILPs) from the state of New South Wales to the entire country represents the most significant countervailing dynamic. Facilitated by the Model Laws project, which is designed to streamline the legal framework across the Commonwealth, it generates new and complex forms of ethical problems for the profession and its regulators by extending the benefits (and problems) of incorporation. The change partially reconfigures the role and function of the lawyer. The legal practitioner is not only an officer of the court and gatekeeper for wider market values; she is also a representative of a corporate entity, with conflicting obligations and loyalties. In the presence of conflict, how does the firm order its commitments and responsibilities? The auditing profession faces structural problems of a similar and, arguably, more pressing magnitude. First, audit firms can now incorporate, as a consequence of the Company Law Economic Reform Programme. Second, and more problematically, auditing ethical standards designed to provide merely a behavioural guide of best practice have since 1 July 2006 been given formal legal standing (Corporations Act, s. 336).

The reliance of fiduciary obligations as a mechanism to prevent *institutional* self-dealing is further weakened given the inter-relationship between the policy acceptance of the existence of structural conflicts of interest and the dominance of the integrated investment banking model. The archetypal integrated investment bank provides a suite of services. These encompass, but are not limited to securities underwriting, which includes conducting due diligence investigations associated with

Initial Public Offerings (IPOs); the provision of analytical reports for affiliated retail brokerage facilities or wider market dissemination; private client money management and proprietary trading – i.e. specific banking units trading on their own account. Each section, however, has a vested interest in advancing the corporate profits of a single institutional entity. The risks associated with managing this process correlate to wider market activity. Cyclical increases in mergers and acquisitions enhance both opportunity and capacity for investment houses to exploit inside information (e.g. Morgenson, 2006; O'Brien 2003; 2007; Stewart, 1992). The situation is exacerbated by the fact that considerable contestation exists on whether and if so at what stage investment banks owe fiduciary duties (e.g. Tuch 2005).

The primary regulatory response has been to foster the creation and maintenance of 'Chinese Walls'. These impose a structural separation within one institution between corporate 'insiders' (e.g. those advising external corporations on mergers and acquisitions) and 'outsiders' (e.g. those trading on either other clients or the bank's own account on the basis of publicly available information).[4] As a largely enabling system of corporate oversight, their origin, like many such innovations in corporate governance design can be traced to industry fear of formal regulation. The first Chinese Wall was created in the United States, for example, as part of settlement talks between the Securities and Exchange Commission and Merrill Lynch in 1968.[5] The resulting settlement was instrumental in the creation of the compliance industry if not necessarily the solution of the problem.

Despite these limitations, commitment to compliance through the erection of Chinese Walls provided a defence when insider-trading provisions were added to the Australian regulatory framework through the Securities Industries Act (s. 128 (7)). Its import was met with derision in the courts. The symbolic nature of the nomenclature

was itself deemed part of the problem. In oft-quoted remarks, Justice Ipp dismissed it as ‘an attempt to clad with antique respectability and impenetrability something that is relatively novel and potentially porous’ (Tomasic, 1989: 89-90) Despite these concerns a parliamentary committee established in 1989 to review the operation of the legislation endorsed the Chinese Walls defence The report based its evaluation on industry assurances that ‘Chinese Walls can and do work. Insufficient evidence has been provided to suggest otherwise’ (Griffith Report, 1990: 34). A caveat was introduced, however: ‘It is evident though that if Chinese Walls are to be effective, rigorous compliance programs need to be in place and should be subject to the scrutiny of the regulatory agencies’ (p. 34).

The process of change intensified with the redrafting of the Corporations Act in 1991. Crucially, while the Chinese Walls defence remained intact, the definition of what constituted insider trading shifted away from the connection of an individual to the *firm*. Rather it attached to the connection an individual or corporate entity (through the doctrine of legal personality) had with the *information*, a move justified on public policy terms as improving market integrity (Lyon and du Plesis, 2005: 9). This formulation also has the effect of overriding problems of mounting prosecutions under either classical or misappropriation theories of insider trading (see Cohen, 2006; Manne 1962b). Mere possession of non-disclosed information is a sufficient barrier to prevent trading. The information does not have to be tangible form, nor does it have to be concrete. Under current Australian law a prosecution can be brought if it is demonstrated that the trader in possession of the information knew it had not been disclosed and that if it had it would have had a material impact on the price of the securities in question (Corporations Act 2001, s. 1042D). The legislation also allows

the bringing of civil suits for insider trading violation, which with lower standards of proof, enhance the chances of successful litigation.

An expansive definition of insider trading, however, is not in itself a guarantee of success. Insider trading remains notoriously difficult to prove, based largely on circumstantial evidence and contestable inference. The complexity of the law itself mitigates against the effectiveness of continuous disclosure rules. As Ian Ramsay (2005: 6) has pointed out 'it may be precisely where companies are exempt from the continuous disclosure rules – where, for example, they are not required to disclose information because it concerns an incomplete proposal or negotiation – that much insider trading occurs.' This is further compounded by continued disputation over whether investment banks do, in fact, owe fiduciary obligations to their clients (Tuch, 2005). It is for this reason that the case taken by the Australian Securities and Investments Commission against the local division of Citigroup crystallize fundamental issues of national and global significance.

3. Unconscionable Predator or Scapegoat? The Citigroup Allegations

The litigation against Citigroup Global Capital Markets has attracted international attention. Its relevance is augmented precisely because the action is being taken against Citigroup as an institution. In a clear indication that the case was designed to have a wider demonstration effect, the ASIC chairman, Jeffrey Lucy, stated that the litigation would comprehensively test whether (and, if so, at what stage) the advisory role performed by an investment bank was fiduciary in nature (Evans, 2006). As such it would clarify two essential issues facing the wider securities industry: what constituted an appropriate system for managing information flows within the corporation and how should this be integrated into wider frameworks for

managing conflicts of interest. Given the fact that ASIC has confirmed to this author that it consulted internationally prior to taking the action, the case, if successful, hints at a potentially significant change in international regulatory strategy. The policy implications will be explored in greater detail below. First, it is instructive to examine the material facts now before the federal court.

Citigroup is alleged to have engaged in ‘unconscionable behaviour’ by trading in the shares of a planned acquisition target by Toll Holdings. Citigroup's Mergers and Acquisitions team had been advising Toll on AUS $4.6 billion bid for Patrick, a rival logistics and transport conglomerate. ASIC alleges that ‘excessive’ proprietary trading in Patrick shares breached a fiduciary duty by Citigroup to act in its client’s best interest. According to the statement of claim, the breach took place on Friday 19 August 2005. The date was significant for two reasons. First, it was the last day of trading prior to the announcement of a hostile takeover. Secondly, Patrick stock was initially languishing, the result of a profit warning the previous day. By lunchtime the bank had amassed a significant holding. Citigroup Global Capital Markets Head of Equities, Malcolm Sinclair, is alleged to have noticed the trading. He is alleged to have had a conversation with a senior executive responsible for managing the trading arm. According to the claim, he told the executive, Paul Darwell: ‘We may have a problem with that.’

The regulator is basing its case, in part, on the materiality provisions of the legislation. These suggest that the conversation (although circumspect and contested by Citigroup) was sufficiently concrete to impute materiality.[6] The claim further alleges that Citigroup ‘did not have in operation arrangements that could be reasonably be expected to ensure that inside information was not communicated to the Citigroup employee who traded in Patrick shares for the benefit of Citigroup’, thus

obviating any reliance on the Chinese Walls defence. It is alleged that the failure to manage this process effectively allowed Citigroup to cheat its client and the market, thus engaging in unconscionable conduct.

Citigroup, for its part, has denied any wrongdoing. In a statement the global bank commented: ‘Citigroup doesn't believe ASIC has any basis of a claim and that this is an attempt to regulate the proprietary trading desks, which are a feature of all major investment banks’ (Gettler, 2006). While such a bullish approach is very much in Citigroup’s interest, it is one that has attracted support across the financial services industry in Australia. Sources in Sydney suggest that the relationship between the regulator and industry ‘has broken down’. According to one highly placed source, ‘it will take years to build up trust; in the short-term we are witnessing a war of attrition.’

As the case works its way through the court system the war of words is becoming more and more vituperative. Lawyers for ASIC claimed in court that Toll was duped by its bankers; Citigroup counter that Toll was informed in writing that the bank would engage in proprietary trading. ‘The only cogent rationale for the case is that someone in ASIC is having an Eliot Spitzer moment,’ says one senior corporate lawyer. Absent a settlement, the courts will adjudicate whether the regulator, like the combative New York State Attorney General before it, has struck at the Achilles Heel of the integrated investment-banking model or overreached in a spectacular manner (see O’Brien 2007).

There is no doubt that lodging a claim against Citigroup gives the Australian regulator enormous potential capacity to force changes to industry practice. It also goes some way to restoring confidence in its reputation as a robust defender of market integrity. By replicating the more aggressive model of enforcement seen recently in the United States, ASIC is also narrowing the gap in national regulatory priorities in

policing global markets. This muscular approach dovetails with attempts to synchronize the enforcement agenda of the International Organization of Securities Commissions (IOSCO) through the development of reciprocal enforcement recognition. The drive towards greater international harmonization and co-operation opens the possibility that the case in Sydney could redefine the duties of investment banks trading on their own account while simultaneously advising clients on complex mergers and acquisitions. If the case is based on a flawed prospectus, however, the reputational risk extends far beyond the standing of ASIC within the Australian investment banking community. Citigroup on the other hand cannot risk an admission that in fact its compliance regime was defective. It is difficult to see, therefore, how either side can back down with losing significant credibility.[7] This escalation imperative, in turn, raises an important wider corporate governance design and accountability question. Does the displacement of consultation by litigation improve industry practice by securing more effective compliance or create uncertainty and devalue intangible drivers such as the inculcation of esteem or the avoidance of disesteem?

Certainly, the timing of the litigation was serendipitous. It was announced just weeks before the high-profile publication of a discussion document on how industry was handling the management of conflicts of interest (ASIC, 2006). The policy justification outlined there mirrored the measures to combat defects with analyst research on Wall Street in 2003. Even the language deployed was redolent of US sensibilities: conflicts not only impaired the quality of advice but gave *unfair* advantages that distorted the market through a lack of *transparency*, *accountability* and *efficiency*. The document implied industry assertion was a defective shield and that probity could only be assured through ongoing surveillance. The response was

overwhelmingly negative. The regulator was deemed to be at best naïve. 'If conflicts were as easy to manage as ASIC suggests, I would not get paid the salary I do,' was the dismissive response of one senior compliance officer. 'The conflicts of interest that plagued the US market are neither as systemic nor problematic in Sydney,' another industry interlocutor opined. Significantly, no advice on proprietary trading was provided in the ASIC document, a state of affairs attributed to the litigation now before the court.

There can be no doubt, however, that the very existence of the litigation impacted on the wider public debate as to whether reform was either necessary or the measures introduced appropriate. According to influential industry sources this is precisely the problem. The peak industry lobby group, the Australian Financial Markets Association, become embroiled through what one observer concedes was a 'selective and highly strategic leak' of its response to the discussion paper. It criticised ASIC for closing down debate and claimed that the court is not a place to design industry standards. This chimes with Citigroup's own defence, which suggests that the case is 'wholly about conflicts management'. Secondly, the indictment itself was subject to considerable consternation. The narrative structure and liberal usage of adjectival descriptors such as 'excessive' mark a significant departure from previous statements of claim. While this may well reflect greater sophistication in the presentation of technical matters, it also opens the ideational space for contestation on perceived grandstanding by the regulator.[8] From a policy dynamic perspective, this is the most troubling aspect. The tactical methods deployed by ASIC, while understandable, may serve to weaken the moral basis of its strategic goals. Already there is evidence that this is the case. As with the Department of Justice litigation against KPMG over its abuse of tax shelters, the key narrative developing is one of

regulatory overreach (O'Brien, 2006). As a consequence the opportunity to debate the more fundamental problem of securing better ethical performance is lost.

4. The Panoptical Promise (and Threat) of Compliance

As noted above, the capacity of compliance to quell misfeasance is intricately linked to corporate and regulatory conception of form and function. Effective compliance must take into account that fact that individual ethical choices are informed and restrained by overarching organizational culture, which in turn is framed by what is legally permissible (and/or politically justifiable). While it is a truism that commercial morality cannot be legislated for, it is possible to design (self) regulatory policies that enhance the impact of intangible factors such as esteem through norm reinforcing compliance programmes (Brennan and Pettit, 2004: 249-66; McAdams, 1997). Indeed, this is the stated intention of US regulatory policy, for example. It is manifested in the metaphorical allusion to governance as conscience and, in practical terms, through the deployment of the negotiated prosecution mechanism. These agreements are explicitly designed to provide greater traction for internally constructed (if calibrated) ethical procedures. Most do not explicitly prohibit lines of business; rather they ensure that the decision-making process is sufficiently robust to give cognisance to an ethical dimension (if only for utilitarian purposes).

The mechanism is further buttressed by the disclosure imperatives that underpin Sarbanes-Oxley and, indeed, the wider securities architecture. The rhetoric of transparency has long played a powerful role in attempting to condition social practice. Examples include the Louis Brandeis maxim that 'sunlight is the greatest disinfectant' and Felix Frankfurter's justification of the Securities Act, 1933: 'Many

practices safely pursued in private lose their justification in public. Thus social standards newly defined gradually establish themselves as new business habits' (Baldwin, 1984: 42). The problem, heretofore, however, has been that the decision-making process has been shielded from transparency. In large measure this can be traced to deficiencies in the audit as an investigative tool.

The requirement to store documentation electronically, however, makes non-disclosure much more problematic. It provides the mechanism for the corporations themselves (and, by extension external gatekeepers) to inspect the decision-making process in a much more sophisticated manner. Deep-search software programmes are capable of exploring, sifting, highlighting and retrieving information about how decision-making processes are made. As such, information technology functions as the digital mainframe tower in the utilitarian architecture of the Panopticon (Foucoult 1977/1991: 200-1). Technology, however, can only go so far. Its capacity to engineer positive change requires a positive synthesis between the objectives of the watcher and the watched (e.g. Simon, 2005). If compliance is conceived (and policed) as technical rather than substantive in nature is value is limited. Indeed, it is likely to be counter-productive in inculcating norms precisely because of the dissonance between the administration of justice and justice itself. However, if designed to ensure substantive compliance with stated corporate objectives, technology provides, at a minimum, early warning systems of dysfunctional behaviour. Crucially, it also provides a credible defence based on a demonstrable commitment to compliance. As a norm inculcating process, it is irrelevant whether this is done on utilitarian grounds. An inevitable consequence is a heightened awareness of the personal and corporate threat of exposure, and, with it, the erosion of (unwarranted) reputation. Far from a reliance on the floor of legal rules, the emphasis on process can be harnessed to hold

the corporation to a much higher degree of accountability, thus reconfiguring the function of law and its centrality to the corporate governance agenda.

Conclusion:

The management of conflicts of interest has become one of the controversial issues in the new paradigm governing financial markets regulation, with significant contestation over the necessity or wisdom of introducing more restrictive controls. The reform agenda advanced by ASIC in its discussion paper not only reconstitutes the relationship between pivotal actors in policy rationale, design and enforcement. It also raises profound and unresolved wider public policy questions over the internal governance of corporations. Significance extends far beyond the internal governance of the corporation precisely because the mechanisms chosen reinforce prescriptive solutions not necessarily mandated by law. This undermines many of the core theoretical assumptions underpinning the entire governance agenda, in that it suggests the imposition of externally imposed rules are preferable to and more effective than internally devised solutions. It also risks weakening industry commitment to still largely inchoate demands for the integration of the ethical dimension that transcends technical compliance with legal requirements.

Progress on resolving these issues require a much great emphasis on process. It minimises the risk posed to regulatory legitimacy and authority. The empirical search for more effective compliance must be situated within an overarching ethical framework that encompasses the conflicting and conflating interests of the wider polity, the regulatory agency, the corporate entity and individual moral agents working within it. This requires attention to the triangular relationship that exists between compliance, reputation and ethics. Constant oscillation between state and

market control fails to provide a stable basis for effective oversight. In addition, the use (or threat) of coercion undermines the inculcation of norms so necessary for ethical management precisely because it causes key institutional players to retreat into ideational silos. In highlighting the reputational risk associated with flawed understandings of ethics, the academy has the opportunity to make a tangible contribution to improving industry practice (e.g. the form and function of codes of ethics), and to the development of public policy (e.g. problem formulation, policy design and implementation). In so doing, it transcends the normative limitations associated with technical compliance with the letter of the law but derogation from its underpinning principles. Crucially, it shifts the emphasis from the relative merits of specific forms of corporate governance to their wider function. In so doing, we enhance the capacity for self-regulation within a graduated enforcement regime. If we do not, we return like Sisyphus, to toil of truly tragic proportions.

NOTES

[1] For United Kingdom, see *Hutton v West Cork Railway* 23 Ch D 654 (1883), making profit maximisation through efficient use of resources central function of the firm; current UK legislation allows for non-commercial payments (Companies Act 1985 s. 3A (b); for United States, *see Dodge v Ford* 204 MICH 459 (1919) at 507 per Ostrander CJ ('The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself…It is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no-one will contend that if the avowed purpose of the defendant

directors was to sacrifice the interests of shareholders it would not be the duty of the courts to intervene.').

[2] Conversely, it has been argued that outside-dominated systems emerge because of developed markets (e.g. Coffee, 2001). This distinction is particularly important in the Australian context, which while demonstrating the form of an outsider dominated capital market demonstrates many of the characteristics more closely associated with insider modes of control, for example, concentrated ownership and block-holder control (Dignam, 2005). This suggests that privileging shareholder control reforms can serve to exacerbate the problem of entrenched management and provide disproportionate benefits to benefit block-holders.

[3] The fiduciary obligation originates in trust, see *Meinhard v Salmon* (1928) 164 N.E. 545 at 546 ('A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctillo of an honour the most sensitive is the standard of behaviour'). In its most absolutist form, the fiduciary must render her own interests subservient to those of her client unless provided for by informed consent, see *Bristol & West Building Society v Mothew* [1998] Ch. 1, 18 per Millet LJ.

[4] The leading authority in the United Kingdom accepts that Chinese Walls can have a place, unless it can be demonstrated that controls work, there is an assumption that information will travel within the firm (*Prince Jefri Bolkiah v KPMG* [1999] 2 WLR 215 at 235, per Millet LJ).

[5] *Re Merrill Lynch, Pierce, Fenner & Smith Inc*, 43 SEC 933 (1968). The voluntary system was made mandatory through Insider Trading and Securities Fraud Enforcement Act (1988), 15 USC 780 (f).

[6] The courts have interpreted this to include information includes 'that obtained by means of a hint or veiled suggestion from which one can impute knowledge' (*Hooker*

Investments v Baring Bros Halkerton & Partners Securities Ltd 10 ACLR 462 (1986) at 463). Research presented by the Australasian Compliance Institute at its annual conference in Sydney on 27 October 2006 suggested wide variations remain in industry over what constitutes a material breach.

[7] In the United States a corporation can make a strategic decision to settle without admitting liability. Such an option does not exist in Australian law, leaving Citigroup open to potentially costly derivative class actions should it attempt to broker a deal.

[8] The adroit use of media management can facilitate the inculcation of intangible norms through a shaming mechanism, but only if the underlying rationale is accepted. If not, then the strategy could backfire on both the regulator and its policy aims.

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