Brooklyn Journal of International Law

Volume 17
Issue 3
Symposium:
Transnational Insolvency: A Multinational View of Bankruptcy

Article 6

12-1-1991

COMMENTARY: Principles of Investment Business - An Anglo-Australian Perspective

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PRINCIPLES OF INVESTMENT BUSINESS — AN ANGLO-AUSTRALIAN PERSPECTIVE*

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I. Introduction — Fiduciaries

The fiduciary principle of the economic loyalty of a broker to its client characterizes the law of stockbroker and client. Standards of competence and skill are laid down by statutes, cases, and industry rules. Because the securities industry operates through representatives (corporations, brokerages, and securities exchanges), some jurisdictions attempt to strengthen the vicarious liability of the principal for the actions of its agent by confirming that the principal faces nonexcludable responsibility for the actions of its representatives.[1]

This commentary considers the United Kingdom's attempt to reduce the principles for investment business to ten "plain English" commandments setting out the basic duties owed to clients by those in the investment business industry from an Anglo-Australian perspective. These commandments build on best current practice, and are intended to be sufficiently general to readily apply to new situations arising in the rapidly changing

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* This commentary is adapted from an oral presentation given at the International Business Law Center at Brooklyn Law School on January 22, 1991.

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1. *E.g.*, Corporations Act, 1989 (Commonwealth of Australia) § 82, sched. 1362 [hereinafter Australian Corporations Law], Part 7.3, Division 4 (Liability of principals for representatives conduct); Securities and Investments Board, Principles and Core Rules for the Conduct of Investment Business, Core Rule 15 (1991) [hereinafter Securities and Investments Board, Core Rules].

financial sector. In the view of the writer, they provide a plain English precedent for rules for the provision of financial services in comparable jurisdictions such as Australia and the United States.

The fundamental fiduciary principle of the law of principal and agent is that of the economic loyalty owed by agent to principal.[2] The duty of the agent (hereafter, in line with British usage, referred to as the firm) is to act in the economic interests of its principal (client). This principle in the United States has been confirmed as the "Shingle Theory" under which the firm, by the fact of putting up its shingle, impliedly represents that it will deal fairly and competently with its customers (principals).[3] Although the application of the fiduciary duty principle depends on factors such as the nature and the expertise of the client,[4] as well as the nature of the firm's relationship with the client, the British regulator, the Securities and Investments Board (SIB) correctly upholds Professor Gower's dictum that "once an agent, always a fiduciary."[5]

The law of firm and client is a product of legislation,[6] case law,[7] and rules,[8] but nowhere is there one clear statement that can be readily communicated to those in the industry.[9] The

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2. *See* Paul Latimer, *Disclosure and Fair Dealing by Stockbrokers*, 18 ANGLO-AM. L. REV. 335 (1989).

3. *E.g.*, R. JENNINGS AND H. MARSH, SECURITIES REGULATION — CASES AND MATERIALS 625-26 (6th ed. 1987).

4. An investor (such as an execution only client) not relying on the firm's skill, care and diligence who treats the firm as a counterparty is arguably not owed the level of fiduciary duty owed to a client dependent on the firm. But the relationship will still have fiduciary aspects relating to monies and securities held by the broker. Option Investments (Austl.) Pty. Ltd. v. Martin, A.S.L.R. para. 76-004 (CCH) (1981).

5. SECURITIES AND INVESTMENTS BOARD, REGULATION OF INVESTMENT BUSINESS — THE NEW FRAMEWORK 26 (1985).

6. *E.g.*, in the United Kingdom: Financial Services Act, 1986, (U.K.) [hereinafter Financial Services Act]; Companies Act, 1985, (U.K.) [hereinafter Companies Act]; Company Securities (Insider Dealing) Act, 1985, (U.K.); Fair Trading Act, 1973 (U.K.). In the United States: Securities Act of 1933, 15 U.S.C. § 77a (1991); Securities Exchange Act of 1934, 15 U.S.C. § 78a (1991) [hereinafter Securities Exchange Act]; Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 (1991). In Australia: Australian Corporations Law, *supra* note 1, at § 82; Trade Practices Act, 1974 (Austl.) [hereinafter Trade Practices Act].

7. Agency cases are legion. For example, Christopher Barker & Sons v. Commissioners of Inland Revenue, [1919] 2 K.B. 222, 228; Option Investments (Austl.) Pty. Ltd. v. Martin, A.S.L.R. para. 76-004 (1981).

8. The business and the listing rules of the exchanges. *E.g.*, Paul Latimer, *Stock Exchange Usage*, 8 COMPANY & SEC. L.J. 165 (1990) [hereinafter Latimer, *Stock Exchange*].

9. "No one can serve two masters." *Matthew* 6 : 24, which the United States Supreme Court has observed, "is especially pertinent if one of the masters happens to be

British concept of ten easily stated and easily remembered "Commandments" is to be commended as a precedent to be followed by equivalent jurisdictions.

II. Regulation and Self-Regulation of the British Securities Industry

Following deregulation of the British financial sector in the 1980's, regulation of the securities markets is now vested in the Secretary of State for Trade and Industry acting through the Department of Trade and Industry (DTI). Under section 114 of the Financial Services Act of 1986 (the Act), the Secretary of State can transfer functions to "a designated agency."[10] The designated agency has the capacity to issue statements of principle, rules, regulations, and codes of practice, and has the power to promote and maintain standards[11] and a satisfactory system to monitor and enforce the obligations for which it is responsible.[12] The agency can also investigate complaints brought to its attention.[13] To date the first and only "designated agency" is the SIB,[14] a private body at law funded by the industry.[15]

By transfer from the DTI under section 114, the SIB has received extensive powers to monitor and enforce investment activity. It has the power of a DTI inspector over authorized business,[16] the power to prosecute certain cases,[17] the power to be judge and jury in publishing a statement as to a person's misconduct in violating various sections of the Act.[18] The SIB also has the power to apply for injunctions and restitution (disgorgement) orders on behalf of investors.[19] Furthermore, the SIB is

economic self-interest." United States v. Mississippi Valley Generating Co., 364 U.S. 520, 549 (1961), *cited by* L. Loss, Fundamentals of Securities Regulation 963 (1983).

10. If the Secretary of State is fulfilling the requirements of Financial Services Act, *supra* note 6, at sched. 7 (Qualifications of Designated Agency) and the competition requirements in §§ 121-23.

11. Financial Services Act, *supra* note 6, at sched. 7, paras. 2, 5.

12. Financial Services Act, *supra* note 6, at sched. 7, para. 3.

13. Financial Services Act, *supra* note 6, at sched. 7, para. 4.

14. Financial Services Act, *supra* note 6, at § 114(2).

15. A company limited by guarantee.

16. Financial Services Act, *supra* note 6, at §§ 104-06.

17. Financial Services Act, *supra* note 6, at § 201.

18. Financial Services Act, *supra* note 6, at § 60, subject to the safeguards in § 60(2) (written notice), § 60(4) (notice to include reference to Financial Services Tribunal), and § 97(1) (requirement that Secretary of State make a reference to the Tribunal).

19. Financial Services Act, *supra* note 6, at § 61.

immune from civil lawsuits.[20]

The most important role of the SIB in the British system is its power to authorize investment business directly.[21] Without authorization, it is an offense to carry on investment business.[22] Investment businesses may also obtain authorization through membership in self-regulating organizations (SROs)[23] and recognized professional bodies (RPBs), which have been recognized by the SIB as meeting certain standards laid down in the Act. There are currently four SROs.[24] Once recognized, the SRO "regulates the carrying on of [the] investment business [of its members] of any kind by enforcing rules which are binding on persons carrying on business of that kind."[25] Obtaining authorization as an SRO therefore entails acceptance of a regulatory framework at least as demanding as that covering persons directly authorized by the SIB.

Section 48 of the Act authorizes the SIB to make rules regulating the conduct of investment business by authorized persons, and as set out in section 48(2), these rules deal with the prohibition of persons carrying on business, the content of advertisements, disclosure of commissions, mandated disclosure, the settlement of disputes, and accounting requirements. In November 1988, as part of its "New Settlement"[26] in the regulation of financial services, the SIB, in conjunction with the SROs and the RPBs, released a paper entitled "Conduct of Business Rules: A New Approach."[27] The SIB's new approach was welcomed by the DTI[28] and was followed in March 1989 with another SIB pa-

20. Financial Services Act, *supra* note 6, at § 187.

21. Financial Services Act, *supra* note 6, at §§ 25-30.

22. Financial Services Act, *supra* note 6, at §§ 15-21.

23. Financial Services Act, *supra* note 6, at §§ 7-14.

24. The four self-regulating organizations (SROs) are: (1) The Securities and Futures Authority (SFA) (resulting from the merger of the Association of Futures Brokers and Dealers (AFBD) and The Securities Association (TSA)); (2) the Financial Intermediaries Managers and Brokers Regulatory Association (FIMBRA); (3) the Investment Management Regulatory Organisation (IMRO); and (4) the Life Assurance and the Unit Trust Regulatory Organisation (LAUTRO).

25. Financial Services Act, *supra* note 6, at § 8(1).

26. This is the term used by the Securities and Investments Board (SIB) itself, *e.g.*, Eva Lomnicka, *The "New Settlement" in the Regulation of Financial Services*, 1990 BRIT. BUS. L. 254.

27. *Noted in* FINANCIAL SERVICES REPORTER (CCH) para. 96-116 (1988) [hereinafter 1988 REPORTER].

28. DEPARTMENT OF TRADE AND INDUSTRY, CONSULTATIVE PAPER, POSSIBLE CHANGES TO THE FINANCIAL SERVICES ACT 1986, *noted in* BARRY RIDER, CHARLES ABRAMS, EILÍS FERRAN, GUIDE TO THE FINANCIAL SERVICES ACT 1986, para. 602 (1989).

per, "A Wider Role for SIB's Principles of Conduct: the next stage of the new approach."[29] Three tiers are planned under this "New Settlement," and the principles of conduct in force from April 1990 together with the second tier, the Securities and Investments Board Core Rules (released early 1991) (hereafter the "Core Rules") are designed to form the essential "spine" of the United Kingdom regulatory system. These rules are to be supplemented by the third tier rules, and guidance is to be prepared by the appropriate SRO under the supervision of the SIB.

The principles of conduct are a plain English[30] restatement of centuries of statutory, common law, and equitable case law principles expressed in a user-friendly style, and are designed to move away from the more traditional, cumbersome and legalistic tone of broker/client law.[31] They apply to all persons authorized directly by the SIB,[32] by the SROs, and by the RPBs. The principles also apply to the marketing activities and pension fund management of insurance companies and friendly societies. However, the enforcement and monitoring of these principles of conduct is a matter of self-regulation by the industry through the SROs and the RPBs.[33] In the words of the SIB, the object of its review of the existing rulebook is to make the SIB rules clearer and to "enhance their effectiveness, and also to present them in a more coherent and logical structure,"[34] rather than to change their substance. Individual SROs are not free to adapt this common core and are responsible for monitoring and enforcing the principles as they apply to those they regulate.[35] To be

29. *See generally* FINANCIAL SERVICES REPORTER (CCH) para. 96-161 (1989) [hereinafter 1989 REPORTER].

30. Statutes, cases, legal documents, and official documents can use clarity of expression without affecting their accuracy. *E.g., Current Topics, "Legalese" and "Court-speak"*, 59 AUSTRALIAN L.J. 189 (1985); LAW REFORM COMMISSION OF VICTORIA, PLAIN ENGLISH AND THE LAW (1987), *cited in* 62 AUSTRALIAN L.J. 496 (1988).

31. Known colloquially as the "Ten Commandments," these principles are made under the Financial Services Act, *supra* note 6, at § 47A; in relation to friendly societies, they are made under sched. 11, para. 13A (1990).

32. Financial Services Act, *supra* note 6, at §§ 25-30.

33. SIB regulation is applicable only to those directly authorized by it.

34. SECURITIES AND INVESTMENTS BOARD, CONDUCT OF BUSINESS RULES: A NEW APPROACH (1988), *quoted in* 1988 REPORTER, *supra* note 27, at para. 96-116.

35. Proposed §§ 47B of Financial Services Act, *supra* note 6, which would have allowed for modification or waiver of statements of principle in particular cases, received a negative response because of the risk of undermining the principles and is unlikely to be proclaimed. *See* SECURITIES AND INVESTMENTS BOARD, THE PROPOSED PRINCIPLES FOR INVESTMENT BUSINESS, Principle 6, *noted in* FINANCIAL SERVICES REPORTER (CCH) Para. 96-230 (1990) [hereinafter 1990 REPORTER].

entrusted with this power of regulation, an SRO/RPB must fulfill the recognition requirements set out in the Act. These requirements include membership qualifications, safeguards for investors, taking account of costs of compliance, monitoring and enforcement capacity, investigation of complaints, and promotion and maintenance of high standards of integrity and fair dealing in the carrying on of investment business.[36]

Self-regulation by SROs and RPBs builds on the standards, traditions, expectations, and of course the self-interest of the centuries-old self-regulation of the investment industry. It vests authority in, and places responsibility on, the self-regulators, as well as the not so insignificant costs of self-regulation.[37] The Act seeks to ensure that the self-regulators rigorously require their members to maintain the highest ethical standards. The system works best in the form of "co-regulation" by government and self-regulator, as in the United States, Canada, Britain, and Australia.[38] Although the government in such a system authorizes stock exchanges and provides the legislative framework and licensing standards, the daily administration is in the hands of the exchange, SRO or RPB, subject to the overriding power of government to intervene. Because SRO/RPB rules have contractual authority, the self-regulators have in effect captured the law-making process.[39] The rules as "instruments" are passed independently, and unlike statutory instruments, they do not have the benefit or burden of scrutiny and approval by parliament.[40]

Self-regulation has many reported benefits such as industry

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36. Financial Services Act, *supra* note 6, at § 10, sched. 2, and § 18, sched. 3.

37. Critics define self-regulation as "pay for it yourself."

38. Australia's regulator is the Australian Securities Commission (ASC), a federal government Commission established under the Australian Securities Commission Act, 1989, (Austl.). It administers federal law called the Corporations Law, a schedule of the Corporations Act 1989 (Austl.), *see supra* note 1. As in the United Kingdom, the ASC is the lead regulator of industry-based SROs. The ASC took over on January 1, 1991, from the previous state-based National Companies and Securities Commission which successfully led Australia's then State and Territory based "co-operative scheme for companies and securities," which existed from 1982 to 1990.

39. The SIB rule book is made under statutory authority to legislate conferred by the Financial Services Act, *supra* note 6, at §§ 48-49, 51-55, 107 and transferred to it thereunder by the Department of Trade and Industry. In contrast, the SRO and Recognized Professional Bodies (RPB) rule books are not made under any statutory power. Instead, they are enforceable by reason of the contract that exists between the SRO/RPB and its members/certified persons. The only "statutory" link, noted in the text accompanying note 43, is that the rule book has to be judged by the SIB as "adequate."

40. The rules are technically not statutory instruments. The Financial Services Act, *supra* note 6, at sched. 9, para. 5, operating in lieu of § 205 and § 205A.

expertise and flexibility of response. It can be cost-effective if paid for by the industry and administered by high caliber and high income private sector staffing. Whereas government can only regulate by prescription, industry can self-regulate by enforcement of legal sanctions as well as by upholding the industry's ethical standards.[41] However, self-regulation can fail if it is not externally monitored. In a 1965 report by a Canadian Royal Commission, the then self-regulation on the Toronto Stock Exchange (prior to the introduction of external supervision of the Exchange) was found to display the following three weaknesses: (1) the rulemaking did not keep pace with loopholing deficiencies in the rules; (2) there was widespread aberration from strict observance of the spirit of the rules; and (3) there was "woeful lack of any effective surveillance to ensure the adherence to rule."[42] Self-regulation can also add to government regulation and costly and inefficient duplication of efforts.

Until 1990, SRO and RPB rule books had to follow that of the SIB by passing the equivalence test. Under the equivalence test the SROs/RPBs had to match the SIB's parent rule book. Absent actual statutory power, the SIB could therefore still indirectly regulate the conduct of the members of SROs/RPBs by setting the standards to be followed. In 1990, this equivalence test was replaced with a test of adequacy: rules and statements of principle of an SRO/RPB must "afford an adequate level of protection for investors."[43] The new test allows room for overall judgment instead of a legalistic comparison of rules, and it differs from the old equivalence test in three important ways: (1) the removal of the old statutory requirement to balance investor protection offered by the SRO/RPB rulebook with that of the SIB; (2) consideration of the rule books as well as statements of principle, and any other statutory rules or codes of conduct; and (3) consideration of other factors beyond the rulebook itself, such as effectiveness of enforcement and other controls.[44]

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41. Roberta S. Karmel, *Securities Industry Self-Regulation — Tested by the Crash*, 45 WASH. & LEE L. REV. 1297, 1304-1313 (1988).

42. ONTARIO ROYAL COMMISSION, THE WINDFALL REPORT 100 (1965), *cited in* Paul Latimer, *Regulation of Securities Industry Intermediaries — Australian Proposals*, 9 U. PA. J. INT'L BUS. L. 1, 13 (1987); Alan C. Page, *Self-regulation: The Constitutional Dimension*, 49 MOD. L. REV. 141 (1986).

43. Companies Act, *supra* note 6, at § 203(1) substituted paras. 3(1), (2) to Financial Services Act, *supra* note 6, at sched. 2 for SROs. Companies Act, *supra* note 6, at § 203(2) substituted para. 3 to sched. 3 for RPBs.

44. SECURITIES AND INVESTMENTS BOARD, REPORT OF THE SECURITIES AND INVEST-

As confirmed by many commentators, the deregulation of the British securities markets in the 1980's was a reaction to the external forces of the internationalization of capital markets and the deregulation of other major financial markets through the 1980's.[45] The thin or nonexistent rule books have given way to the new principles set out in the three tiers of regulation.

III. THE PRINCIPLES OF CONDUCT

The principles of conduct are intended to indicate standards of conduct, such as standards in assessing negligence.[46] The principles are not actionable by an investor under section 62 of the Act because they are not in the classes specified, and because of their specific exclusion by section 47A(3).[47] Had they given rise to actions for damages, they would no doubt have been differently drafted.[48] However, breach of a principle is also likely to be a breach of the SIB or SRO/RPB rule book which is clearly actionable under section 62, although only by a "private investor."[49] In addition, SROs can discipline their members for breaches of the principles, with the ultimate sanctions being suspension or removal of authorization.

Private action is one of the successes of the United States Securities Exchange Act of 1934 (the Exchange Act). Courts in the United States have recognized a private right of action under section 10(b)(5) of the Exchange Act and Rule 10b-5, promulgated thereunder, since the 1940s. Rule 10b-5 basically proscribes misleading, deceptive, or fraudulent conduct, and has given rise to a vast jurisprudence in Securities and Exchange Commission and private proceedings in a wide range of financial services litigation. In similar plain English, Australia's compara-

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MENTS BOARD FOR 1989/90 33 (1990).

45. *E.g.*, MICHAEL MORAN, THE POLITICS OF THE FINANCIAL SERVICES REVOLUTION (1990).

46. SECURITIES AND INVESTMENTS BOARD, THE PROPOSED PRINCIPLES FOR INVESTMENT BUSINESS, Principle 6 (1990), *reprinted in* 1990 REPORTER, *supra* note 35 at, para. 96-230.

47. Financial Services Act, *supra* note 6, at §§ 47A(3), 62.

48. SIB favored the principles which are now the core rules to be available for the purpose of civil claims under Financial Services Act, *supra* note 6, at § 62. They would have had the status of a statutory tort, enforceable by investor against firm. 1989 REPORTER, *supra* note 29, at para. 96-161.

49. As defined in the Financial Services Act, (Restriction of Right of Action) Regulations 1991 (No. 489 of 1991), d.2, a "private investor" means an investor "otherwise than in the course of carrying on investment business" (in the case of an individual), and an investor "otherwise than in the course of carrying on business of any kind" (in the case of "any other person," including a company).

ble section 52 of its Trade Practices Act of 1974 (the Trade Practices Act) sweepingly proscribes engaging in conduct "that is misleading or deceptive or is likely to mislead or deceive." Originally intended as a consumer protection section especially targeting advertisers, there now appears to be no limit to the inventiveness of section 52 litigation as it spreads from advertising to misrepresentation, breach of contract, passing off, defamation, negligence, corporate law, and the securities industry.[50] Section 52 gives standing to sue to any person misled or deceived. The success of section 52 as a catch-all has led to the adoption of equivalent words as section 995 of the Australian Corporations Law as from January 1, 1991. Further, an injunction to restrain conduct which is misleading or deceptive may be granted under section 80 of the Trade Practices Act on the application of the Attorney-General, the Australian Trade Practices Commission, or "any other person" to prevent threatened as well as actual misleading or deceptive conduct.[51] In addition to this, Australian securities law specifically contains an important private enforcement section in Corporations Law section 777.[52] This section empowers the court to order compliance with, or enforcement of, the business or listing rules of the exchange on the application of the Australian Securities Commission, the securities exchange, or an aggrieved person.[53] Since the predecessor of this section was enacted in 1976, the exchange has never sought to enforce this section, fearing a court order of costs against it if unsuccessful. Court decisions have attempted to narrow the definition of an aggrieved person to a person with a genuine grievance so that not just any shareholder would have standing.[54] The better view, expressed in relation to a parallel section, takes the expansive approach that standing is available to any person whose interests have been affected.[55]

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50. *E.g.*, Philip H. Clarke, *Misleading or Deceptive Conduct in Relation to Takeovers*, 7 COMPANY & SEC. L.J. 108 (1989); PAUL LATIMER, AUSTRALIAN BUSINESS LAW 447-57 (1990).

51. *See infra* note 55.

52. Australian Corporations Law, *supra* note 1, contains a parallel enforcement provision at § 1140 for private action against futures exchanges, clearing houses, or futures associations.

53. Australian Corporations Law, *supra* note 1, at § 777.

54. Robox Nominees Pty. Ltd. v. Bell Resources Ltd., 4 A.C.L.C. 164 (1986).

55. The Broken Hill Proprietary Co. Ltd. v. Bell Resources Ltd., 2 A.C.L.C. 157 (1984). In relation to the forerunner of Australian Corporations Law, *supra* note 1, at § 1324, *Broken Hill* overrides earlier restrictive interpretations on this standing requirement. Wide standing given in the equivalent "any other person" in Trade Practices Act,

As discussed in Part II, the SIB "New Settlement" has resulted in a clearly stated and universal set of principles of conduct stating the duty owed by securities firms to clients. They are designed to encapsulate, express, and build on current best practice, and to be readily understood not only by financial experts, but by all those in the financial markets. The principles are intended to be sufficiently general to be readily applied to all new situations without the need for frequent amendment and updating that has characterized the rule books to date.[56] The principles open with a preamble and objects clause encapsulating their purpose and objects, and, most importantly, state in Introduction 2 that they are not exhaustive of the standards expected. Common law and equitable principles (such as the law of fiduciaries) are therefore preserved.[57] Under statutory interpretation principles, the preamble may be referred to as an aid to interpretation so long as it does not contradict clear and unambiguous language in the statute (or in this case, the principles of conduct):

> Statements of Principle
> Introduction
> (1)These principles are intended to form a universal statement of the standards expected. They apply directly to the conduct of investment business and financial standing of all authorized persons ("firms"), including members of recognized self-regulating organizations and firms certified by recognized professional bodies.
> (2)The principles are not exhaustive of the standards expected. Conformity with the principles does not absolve a failure to observe other requirements, while the observance of other requirements does not necessarily amount to conformity with the principles.
> (3)The principles do not give rise to actions for damages, but will be available for purposes of discipline and intervention.
> (4)Where the principles refer to customers, they should be taken to refer also to clients and to potential customers, and

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supra note 6, at § 80, has led to many public interest cases. *See, e.g.*, Phelps v. Western Mining Corporation Ltd., 33 F.L.R. 327, A.T.P.R. 40-077 (1978) (misleading mining advertisements); Australian Federation of Consumer Organisations Inc. v. Tobacco Institute of Australia Ltd., 100 A.L.R. 568, A.T.P.R. 40-916 (1988), A.T.P.R. 41-079 (1991) (misleading tobacco advertising).

56. SECURITIES AND INVESTMENTS BOARD, THE PROPOSED PRINCIPLES FOR INVESTMENT BUSINESS, CONSULTATIVE PAPER No. 33, 7 (1990).

57. *See id.* at Principle 6.

where they refer to a firm's regulator, they mean SIB, or a self-regulating organization or professional body which regulates the firm.
(5)Although the principles may be taken as expressing existing standards, they come into force formally, with additional sanctions resulting, on 30 April 1990.

After this introduction, the principles then continue as follows:

The Principles
(1)Integrity
A firm should observe high standards of integrity and fair dealing.

The wholeness or honesty encompassed by the word "integrity" is manifest in the high standard expected by Principle 1. Although legal definitions are not required to explain "integrity and fair dealing," the words incorporate the high ethical conduct expected of the securities industry, which are characterized by words such as "fidelity," "integrity," "trust," and "honour."[58] In the words of Australian case law,

> [t]he occupation of sharebroking demands high standards of integrity. In carrying on his occupation a sharebroker acts, not for himself, but for his client. His remuneration is his brokerage, or commission. Clients, some with great, others with little, business acumen and ability to protect themselves, seek and act on his advice and permit him to handle their money and their shares. Those clients are entitled to expect from a broker not only competence, but also integrity and absence of conflicting personal interests. His position is one of trust and responsibility. By the recognition and pursuit of the high traditions of their occupation, brokers have aspired to the status of an honourable profession. The price they must pay for this status is that they forswear all compromise of their integrity, and that they repudiate the creation of personal interests which could bring them into conflict with their duty to their clients.[59]

Certainly the term encompasses the avoiding of conflicts of interest as required in equity, as later set out in Principle 6.

(2) Skill, Care and Diligence
A firm should act with due skill, care and diligence.

58. In line with the motto of London's International Stock Exchange, "My word is my bond."

59. Bonds & Securities (Trading) Pty. Ltd. v. Glomex Mines N.L., 1 N.S.W.L.R. 879, 891 (1971).

The need for proper skill, care, and diligence in the carrying out of duties permeates all business. The concepts mean that those holding themselves out as being qualified to give investment advice, and who stand to profit when their advice is followed, are held to a duty of care commensurate with their responsibilities.[60] This principle obviously overlaps with Principle 4's "know your client" rule, discussed below. Diligence imports the concept of industriousness and attentiveness to duties. In theory, the applicable standard is that which a reasonable person would expect of an ordinarily competent and alert firm in the circumstances, but in practice the courts expect a high standard of skill, care, and diligence in specialized areas like professional practice. Tort law confirms over and over again the duty of care expected of the professional adviser for negligent misstatements.[61]

> (3) Market Practice
> A firm should observe high standards of market conduct. It should also, to the extent endorsed for the purpose of this principle, comply with any code or standard as in force from time to time and as it applies to the firm either according to its terms or by rulings made under it.

Principle 3 deals with codes not covered by the Financial Services Act. It went through a number of public drafts, and was originally headed "Observance of Standards," specifying for a firm compliance with outlying standards, for example:

> applicable provisions of any code or set of standards published by its regulator, by the Bank of England or the Takeover Panel, or by any authority recognized by law in the United Kingdom (or, where the firm carries on activities affecting any other country, in that country) as responsible in the public interest for the supervision or regulation of financial activities.[62]

These other codes include the Takeover Code administered by the Takeover Panel and The Grey Book Market Code

60. *See, e.g.*, Meddick and Meddick v. Cutten and Harvey, 36 S.A.St.R. 542, 556 (1984); DEPARTMENT OF TRADE AND INDUSTRY, FINANCIAL SERVICES IN THE UNITED KINGDOM — A NEW FRAMEWORK FOR INVESTOR PROTECTION 20 (1985) [hereinafter DEPARTMENT OF TRADE AND INDUSTRY, FINANCIAL SERVICES].

61. In Anglo-Australian law, starting with Hedley Byrne & Co. Ltd. v. Heller and Partners Ltd., [1964] App. Cas. 465.

62. SECURITIES AND INVESTMENTS BOARD, REGULATION OF THE CONDUCT OF INVESTMENT BUSINESS: A PROPOSAL (1989), *reproduced in* 1989 REPORTER, *supra* note 29, at para. 96-196.

(wholesale markets in Sterling, Foreign Exchange, and Bullion) administered by the Bank of England. Principle 3 then restricted this expectation under the new heading "Best market practice" to cover only standards of market conduct and codes or standards issued or approved by the relevant regulator.[63] It was expected that FIMBRA, IMRO and TSA would approve the Takeover Code for this purpose, that AFBD, IMRA and TSA would endorse the Bank of England Grey Book, and that AFBD would endorse the Oil Markets Code.[64] In fact, free standing endorsement by SROs has now been abandoned, but SIB still plans to endorse codes for the purposes of Principle 3. The third and final draft of Principle 3, now headed "Market practice," requires the observance of "high standards of market conduct." It also requires compliance with any code or standards "to the extent endorsed for the purpose of this principle."[65] But in requiring observance of high standards of market conduct, no mention is made of traditional fiduciary duties or to the common law duties owed by an agent to its principal. Presumably these are encapsulated in Principles 1 and 6. "Market conduct" goes wider than regulatory rules, and covers at least the SIB rules, the rules of the SROs and the RPBs, and the rules and practices of the International Stock Exchange and other Futures and Commodities.

This compliance requirement would have had the desirable effect of enabling the SIB to enforce the Takeover Code at its own instance. Indeed, such power should exist, as it does under equivalent legislation in Australia.[66] To counter this possibility, the SIB issued an instrument, Codes or Standards: SIB's endorsement under Principle 3,[67] which restricts the SIB's power to enforce the Takeover Code to situations at the request of the Panel, thereby preserving the Panel as sole arbiter on the Takeover Code. The instrument also restricts SIB's powers to seek injunctive relief, or to prevent parties to takeover bids from seeking SIB intervention, with the result that bid disputes

63. SECURITIES AND INVESTMENTS BOARD, THE PROPOSED PRINCIPLES FOR INVESTMENT BUSINESS (1990), *reproduced in* 1990 REPORTER, *supra* note 35, at para. 96-230.

64. *See supra* note 24.

65. Issued by SIB on March 15, 1990 (in force from April 30, 1990) under authority of Financial Services Act, *supra* note 6, at § 47A, *reproduced in* 1990 REPORTER, *supra* note 35, at para. 96-256.

66. *See supra* notes 52 and 55.

67. Issued by SIB in 1990.

would be increasingly decided by the courts rather than by the Panel. In any event, section 47A of the Act deals with the interaction of Financial Services Act regulators enforcing the Principles, with the enforcement of other codes by other regulators. Section 47A(5) enables enforcement by regulators which are not covered by the Financial Services Act regulator. Proposed section 47B (not yet in force, and unlikely to ever be proclaimed due to its widespread criticism) further deals with the interaction of the principles with the SRO and RPB rule books in allowing modification or waiver of statements of principle in particular cases.[68]

> (4) Information about Customers
> A firm should seek from customers it advises or from whom it exercises discretion any information about their circumstances and investment objectives which might reasonably be expected to be relevant in enabling it to fulfill its responsibilities to them.

In accordance with Principle 4, investment firms should take account of the expertise, needs, and resources of their customers before recommending particular transactions. This restates the "know your client" rule found in international securities laws, whereby an adviser is to have a reasonable basis for believing that recommendations are suitable for the requirements of its customer. To fulfill this duty, an adviser must have considered and investigated the subject matter of the recommendation as is reasonable in the circumstances to determine that it is appropriate in view of the investment objectives, financial situation, and the particular needs of the customer. Australia's "know your client" rule is contained in the Corporations Law.[69] Breach of the Australian rule gives rise to a claim for damages for any loss suffered.

> (5) Information for Customers
> A firm should take reasonable steps to give a customer it advises, in a comprehensible and timely way, any information needed to enable him [sic] to make a balanced and informed decision. A firm should similarly be ready to provide a customer with a full and fair account of the fullfillment [sic] of its

68. Contained in Companies Act, *supra* note 6, at § 192; *supra* note 35.

69. *E.g.*, SECURITIES AND INVESTMENTS BOARD, THE FINANCIAL SERVICES (CONDUCT OF BUSINESS) RULES, rule 5.01(1) [hereinafter SECURITIES AND INVESTMENTS BOARD, CONDUCT OF BUSINESS]; Australian Corporations Law, *supra* note 1, at § 851.

responsibilities to him.

Customers need information for investment decisions in line with the aphorism that a "securities market is a market for information." Principle 5 requires a firm to keep a customer informed, and places the firm under a statutory duty of disclosure. This is over and above the disclosure requirements of a fiduciary in equity law. Information to be disclosed includes such matters as: (1) any material interest which a firm might have in a proposed transaction; (2) the capacity in which it would act (principal, agent, jobber, market maker); (3) fees, benefits and commissions;[70] (4) remuneration it may receive from other parties interested in the transaction; and (5) any other factors potentially affecting its independence.[71] A firm with a "material interest" in a transaction must not act unless it has "take[n] reasonable steps to ensure fair treatment for the customer."[72]

Securities laws target advertising. The Financial Services Act of 1986 (United Kingdom) requires "investment advertisements"[73] and Conduct of Business Rules to be issued and approved by an "authorised person." Misleading statements and practices are proscribed under international securities regulation laws to restrain false information from the market.[74]

> (6) Conflicts of Interest
> A firm should either avoid any conflict of interest arising or, where conflicts arise, should ensure fair treatment to all its customers by disclosure, internal rules of confidentiality, declining to act, or otherwise. A firm should not unfairly place its interests above those of its customers and, where a properly informed customer would reasonably expect that the firm would place his [sic] interests above its own, the firm should live up to that expectation.

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70. *E.g.*, Australian Corporations Law, *supra* note 1, at § 849, places a statutory obligation on a "securities adviser" making a "securities recommendation" to disclose particulars of "any commission or fee, or any other benefit or advantage, whether pecuniary or not and whether direct or indirect," *elaborated in* NATIONAL COMPANIES AND SECURITIES COMMISSION, PRACTICE NOTE No. 319 (1990).

71. DEPARTMENT OF TRADE AND INDUSTRY, FINANCIAL SERVICES, *supra* note 60, at 20.

72. SECURITIES AND INVESTMENTS BOARD, CORE RULES, *supra* note 1, at Core Rule 2.

73. As defined in Financial Services Act, *supra* note 6, at § 57(2), and subject to exemptions set out in § 58 such as issues by government and local government, issues by any central bank (including the Bank of England and Australia's Reserve Bank), and various exempt issues (by investment exchanges, clearing houses, Lloyd's, listed money market institutions, and others).

74. *E.g.*, Financial Services Act, *supra* note 6, at § 47; Securities Exchange Act, *supra* note 6, at Rule 10b-5; Australian Corporations Law, *supra* note 1, at § 995.

The duty of economic loyalty encompassed by the avoidance of conflicts of interest is set out in Principle 6. Conflicts of interest are to be avoided, and the firms's private interests are not to conflict with the interests of the customer. In fact, Principle 6 offers a firm a choice between what can be described as a high road (to avoid any conflict), and a low road (if there is a conflict, to ensure fair treatment). But in making this choice, a firm must comply with Core Rules 2 and 36. Core Rule 2 requires a firm which has a material interest in a transaction "to ensure fair treatment for the customer." Core Rule 36 builds on section 48(2)(h) of the Act to isolate information behind "Chinese Walls" in appropriate circumstances.[75]

Disclosure of information is one of the overriding principles of laws regulating the securities industry. At common law, an agent is under a duty of full disclosure of all matters likely to influence the conduct of the principal, and in particular, an agent cannot enter any transaction where its personal interest may conflict with the legal duties owed to the principal, unless the principal has given full consent upon disclosure of all material circumstances.[76] Securities laws require securities firms to give priority to clients' orders. A firm is not to compete with a client in a securities transaction unless the client's instructions cannot be fulfilled, for instance instructions on price.[77]

The SIB principles conform to agency principles. As noted under Principle 5, rule 5.08 requires disclosure by a firm recommending a transaction of any material interest it may have in the transaction.[78] The firm's independence must be maintained, and associations with particular institutions must be disclosed.[79] Hence, overriders and other inducements are prohibited as they influence the adviser's judgment and introduce conflict of inter-

75. *E.g.*, Norman S. Poser, *Chinese Walls or Emperor's New Clothes? Regulating Conflicts of Interests of Securities Firms in the U.S. and the U.K.*, 9 MICH. Y.B. INT'L LEGAL STUD. 91 (1988). Financial Services Act, *supra* note 6, at § 48(6) provides that compliance with the Chinese Wall provisions avoids the risk of misleading statements and practices in breach of § 47.

76. A principle of long standing, *see, e.g.*, Burton v. Wookey, 6 Madd. 367, 56 E.R. 1131 (1822); Rothschild v. Brookman, 2 Dow. & Cl. 188, 6 E.R. 699 (1831); Fullwood v. Hurley, 1 K.B. 498 (1928); F.M.B. REYNOLDS, BOWSTEAD ON AGENCY 164 (1985).

77. *E.g.*, Australian Corporations Law, *supra* note 1, at § 844.

78. SECURITIES AND INVESTMENT BOARD, CORE RULES, *supra* note 1, at Core Rule 2; SECURITIES AND INVESTMENTS BOARD, CONDUCT OF BUSINESS, *supra* note 69, at rule 5.08.

79. SECURITIES AND INVESTMENT BOARD, CORE RULES, *supra* note 1, at Core Rule 2; SECURITIES AND INVESTMENTS BOARD, CONDUCT OF BUSINESS, *supra* note 69, at rule 5.08.

est.[80] The Australian Corporations Law requires disclosure of commissions or fees received.[81] Principal trading by the firm raises the potential for conflict unless disclosed and consented to. Securities laws, for example, prevent a securities dealer dealing in any securities with a person who is not a dealer (the client) unless first informing that person that the dealer is acting in the transaction as principal and not as agent.[82] In fact, two disclosures to the client are required: (1) at the commencement of the contract of dealing; and (2) ex post facto in the contract note provided as evidence of the transaction.

Arguably, Principle 6 sets out a lower standard than that imposed on an agent by the common law. Case law states clearly that "[n]o man can in this court, acting as an agent, be allowed to put himself into a position in which his interest and duty will be in conflict."[83] Compliance with the principles may still result in conflict of interest at common law. Therefore, this raises the issue of conflict arising when statutory rules and nonstatutory law (common law or equitable principles such as those on fiduciaries) apply to the same activity. The rules of statutory interpretation state that unless there is a specific provision to the contrary, the pre-existing law continues with only the changes necessary to give effect to the statute.[84] Indeed, at the time of writing, the issue of the relationship between regulatory rules and fiduciary duties is before the English Law Commission and the Scottish Law Commission.[85] Two views have surfaced: (1) regulatory rules cannot alter the strict obligations of the common law unless expressly enabled by some statutory power; and (2) in defining the duties of a participant in the financial services market, the courts should take account of the regulatory regime to define the extent of the rights and remedies of clients

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80. SECURITIES AND INVESTMENT BOARD, CORE RULES, *supra* note 1, at Core Rule 1; SECURITIES AND INVESTMENTS BOARD, CONDUCT OF BUSINESS, *supra* note 69, at rule 2.04.

81. Australian Corporations Law, *supra* note 1, at §§ 849.

82. *E.g.*, Securities Exchange Act, *supra* note 6, at rule 10b-10a; Australian Corporations Law, *supra* note 1, at § 843.

83. THE LAW SOCIETY OF SCOTLAND, INVESTOR PROTECTION COMMITTEE, RESPONSE TO THE SCOTTISH LAW COMMISSION ANENT FIDUCIARY DUTIES AND THE FINANCIAL SERVICES ACT 7 (1990) [hereinafter THE LAW SOCIETY OF SCOTLAND].

84. *E.g.*, D.C. PEARCE & R.S. GEDDES, STATUTORY INTERPRETATION IN AUSTRALIA 104 (1988).

85. LAW COMMISSION, FIDUCIARY DUTIES AND REGULATORY RULES, ISSUES QUESTIONNAIRE (1990); THE LAW SOCIETY, FIDUCIARY DUTIES AND REGULATORY RULES, RESPONSE TO THE LAW COMMISSION'S ISSUES QUESTIONNAIRE (1991); THE LAW SOCIETY OF SCOTLAND, *supra* note 83.

rather than common law and equitable duties which exceed or are incompatible with those of the regulatory regime. In line with the British compromise, the current view has to lie between these two extremes. There is no reason in principle why statutory and nonstatutory regulatory rules should not be allowed to modify pre-existing fiduciary duties. Common law obligations are modified by nonstatutory regulatory rules, such as contracts on the stock exchange made "subject to" the exchange's own rules.[86] Conformity with the established standard can assist in rebutting an allegation of negligence.[87]

> (7) Customer Assets
> Where a firm has control of or is otherwise responsible for assets belonging to a customer which it is required to safeguard, it should arrange proper protection for them, by way of segregation and identification of those assets or otherwise, in accordance with the responsibility it has accepted.

Agency law has always imposed on an agent duties to the principal regarding the identification and the preservation of the assets of the principal. There is a clearly recognized duty to keep accounts and to segregate the principal's funds to enable identification of the customer's property,[88] and to account to the principal.[89] Clients' money must be paid into a trust account, and firms' accounts must be audited and lodged with the firm's regulator. For the protection of the clients' funds, Principle 7 mandates their segregation for safeguarding while under the control of a securities firm on the basis that the possibility of fraud is reduced and loss through insolvency of the firm is curtailed as the clients' funds could not be used to pay the general debts of the broker.[90] A client's documents of title are also to be safeguarded.[91] Registrable instruments are to be registered in the

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86. Latimer, *Stock Exchange, supra* note 8, at 166.

87. Although Australian law states that the standard of care is not the English subjective test of what is done in the circumstances, Bolam v. Friern Hospital Management Committee, 2 All E.R. 118 (1957), but is instead the objective test of what ought to be done, F. v. R., 33 S.A.St.R. 189 (1983).

88. *E.g.*, SIB's rules made under the Financial Services Act, *supra* note 6, at § 49; THE SECURITIES ASSOCIATION, FINANCIAL REGULATIONS 100 (1987) [hereinafter THE SECURITIES ASSOCIATION]; Australian Corporations Law, *supra* note 1, at Parts 7.5, 7.6.

89. Lupton v. White 15 Ves. Jun. 432, 33 E.R. 817 (1808).

90. DEPARTMENT OF TRADE AND INDUSTRY, FINANCIAL SERVICES, *supra* note 60, at 20; *Re* Goode, 24 F.L.R. 61 (1974) (loss through insolvency).

91. A securities firm can however make use of them as security for a loan to the firmif the client is in debt to the firm. Australian Corporations Law, *supra* note 1, at §

client's name unless the firm is requested to register the instruments in its name.[92] In line with this principle, securities laws restrict the firms' power to use documents of the customer.

> (8) Financial Resources
> A firm should ensure that it maintains adequate financial resources to meet its investment business commitments and to withstand the risks to which its business is subject.

The capital adequacy requirement of Principle 8 is an attempt to provide a safeguard of the financial resources of a firm to help ensure the firm can meet its liabilities, especially its liabilities to customers. Securities laws prescribe minimum capital tests to reflect potential risks.[93] The Australian Corporations Law requires stock exchange firms to lodge deposits with the stock exchange equal to two-thirds of the lowest balance in their trust accounts for the preceding quarter year.[94] The funds, held by the exchange in trust for the firm, are invested in interest bearing term deposits with an Australian bank or with an authorized dealer in the short-term money market to ensure that they are adequate to enable the firm to meet its business commitments.

> (9) Internal Organisation
> A firm should organise and control its internal affairs in a responsible manner, keeping proper records, and where the firm employs staff or is responsible for the conduct of investment business by others, should have adequate arrangements to ensure that they are suitable, adequately trained and properly supervised and that it has well-defined compliance procedures.

Principle 9 places responsibility on the securities firm to accept responsibility for the benefits of its authorization, and its internal affairs are to be organized and controlled in a responsible manner. Records of accounts, transactions, and customer lists, are to be kept, and securities laws mandate various disclosures by means of accounts and registers.[95] Australian law re-

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92. *E.g.*, Australian Corporations Law, *supra* note 1, at § 873.

93. *E.g.*, SECURITIES AND INVESTMENTS BOARD RULES ON FINANCIAL REGULATIONS; THE SECURITIES ASSOCIATION, *supra* note 88.

94. Australian Corporations Law, *supra* note 1, at § 889. Trust accounts are required under Australian Corporations Law, *supra* note 1, at § 866.

95. See discussion of Principle 7 in text accompanying *supra* notes 88-92.

quires registers of a firm's "relevant interest"[96] (the power to control the voting rights attached to a security). Principle 9 also confirms the common law rule that a firm, as controller, is vicariously responsible for its staff. The firm is to have arrangements in place to ensure the suitability, training, and supervision of its staff to ensure the required compliance with the principles and core rules. Breaches of the principles and the second-tier core rules can therefore not be blamed on a staff member. The firm's duties are not transferable.

> (10) Relations with Regulators
> A firm should deal with its regulator in an open and cooperative manner and keep the regulator promptly informed of anything concerning the firm which might reasonably be expected to be disclosed to it.

Principle 10 specifies openness and cooperation in dealing with regulators, and lays down the expectation that a firm will keep the regulator promptly informed of anything relevant to the regulator's task. This requirement is strengthened with the full range of sanctions and penalties for its violation. This recognizes that securities market regulation is a matter of co-regulation, with a government created legislative framework and daily administration in the hands of the SROs/RPBs subject to the right of government to intervene.[97] International securities laws sometimes take this a step further, and provide that in the interests of securities regulation, the self-regulator itself is to cooperate with the lead regulator in the performance of its task, including providing the regulator with full and free access to its facilities.[98] Principle 10 does not impose an affirmative duty on a firm to seek guidance if it is in doubt on a particular area. Instead, the assumption is that the SROs can impose such a duty under their own powers if desired.

IV. Conclusion

In any discussion of the principles of investment business in any legal jurisdiction, the fiduciary duties owed by firm to client are paramount. Plain English principles are a worthwhile prece-

96. Australian Corporations Law, *supra* note 1, at Part 7.7.

97. Securities and Investments Board, The Proposed Principles for Investment Business, Principle 10, *reprinted in* 1990 Reporter, *supra* note 35, at para. 96-230.

98. *E.g.*, Australian Corporations Law, *supra* note 1, §§ 776 (securities exchange), and 1139 (futures exchange).

dent, but they must not lower existing fiduciary duties. The suggestion that the British principles for investment business should be enforceable by investors or others on public interest grounds arguably expects more of the principles than they were intended to achieve. However, breach of a principle is likely to be a breach of the SIB or SRO/RPB rule book. These breaches are actionable by the SRO/RPB in disciplinary proceedings and also by a private investor under the Financial Services Act, and to that extent the British principles achieve their purpose of restatement of the standards expected.