FINANCIAL SERVICES AND FUNDS MANAGEMENT - The Legal Issues

Conduct Rules - From Insider Trading to Client Priority

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INTRODUCTION

Richard Coleman's paper looks at the big picture - the proper aim and structure of regulation of financial institutions in an era of full service financial conglomerates.

The aim of this paper is to descend from the macro to the micro. I will examine some key principles of individual conduct which apply to financial services businesses, particularly funds management businesses.

There is a very large, but reasonably well understood, body of law and practice known to banks, bankers and their advisers as "banking law". A look at the index of a major banking text suggests that its concerns cover areas such as the regulatory framework of Australian banking, the banker/customer relationship, payment instruments and the rights, duties and liabilities of banks in the payment system, securities for advances and loans, documentary credits, the legal characterisation and attributes of various kinds of financial accommodation, privacy, consumer credit and syndicated lending.

The bank of the future is likely to be (if it is not already) a securities firm and funds manager, just as much as a banker. Bankers and their advisers will need to know as much about the law of securities, futures and derivatives, as they do about cheques. Chapter 7 and Chapter 8 of the Corporations Law will become as familiar to them as *Tournier's* case.[1]

This paper will seek to introduce, in a necessarily preliminary way, some of the legal principles governing the conduct of those involved in financial services business, particularly funds management businesses. To do that, it will look at some of the key concepts of Chapter 7 of the Corporations Law, such as insider trading, client priority, "know your client and product" rules and fee and benefit disclosures. It will also look at some general corporate law principles, such as the duty of corporate officers to act honestly and not to misuse their position, as embodied by

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1 *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461.

section 232 of the Corporations Law. Necessarily, it must also cover some of the common law framework governing these activities, touching on such perennial questions as "do funds managers have fiduciary duties?" and the contractual obligations of fund managers and others in financial services businesses.

The aim of the oral presentation accompanying this paper is to cover those areas in a practical way by looking at a number of hypothetical situations. Those hypotheticals involve questions about allocation of securities trades, front-running, client priority, insider trading and personal share dealing by employees of funds management businesses. The written version of this paper aims to describe in a general way the law in these areas, in a way which will supplement the oral presentation.

FIDUCIARY OBLIGATIONS

Despite the comments by a number of members of the High Court in *Hospital Products Limited v United States Surgical Corporation* [2] (the *Hospital Products* case) that courts should not lightly characterise ordinary commercial relationships as fiduciary, fiduciary relationships lurk everywhere in business these days.

The relationships between financial institutions and their customers in the financial services area, and especially in the funds management area, are too complex to admit of any simple generalisations as to whether the relationships so created are fiduciary or, if so, what the consequences of such a fiduciary relationship might be. However, if the relationship between a fund manager and his or her client is fiduciary, the consequences could be profound. Some of these practical consequences are discussed below. It is first appropriate to turn to analyse some of the general principles in these areas in order to establish whether or not the kinds of relationships one sees in financial services businesses (especially funds management business) are fiduciary.

Mason J suggested in the *Hospital Products* case[3] that the fiduciary relationship is one in which:

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

Relationships in the funds management area cover a spectrum. At one end of the spectrum is the kind of relationship which Mason J would very likely consider fiduciary, namely one in which a funds manager is given open-ended discretion to manage funds for an unsophisticated customer in an unregulated and poorly documented relationship in which both parties clearly assume that the manager will "look after" the best interests of the customer. At the other end of the spectrum lies the situation where a large and powerful institutional investor with many millions of dollars available for management, commits funds to a number of specialist managers, subject to detailed mandates and with very limited discretions on the basis of very close monitoring and reporting.

The first relationship may be fiduciary, the second is likely to be primarily contractual (although it may have some fiduciary aspects).

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2 (1984-85) 156 CLR 41.

3 At page 97.

The complexity of the relationships found in funds management businesses and the consequent difficulty of characterising them as fiduciary with any degree of certainty is neatly illustrated by an examination of the well-known public unit trust structure.

In *McLean v Burns Philp Trustee*,[4] Young J said:

> "It must thus be realised that trusts such as the present constitute a special species of trust where the power to manage and what I might call the 'watchdog powers' are deliberately compartmentalised."

Young J was pointing to the separate functions of trustee and manager. Clearly, a trustee is a fiduciary. The manager in this situation though is likely also to owe fiduciary duties to the unitholders. The manager is not a mere delegate of the trustee. This point was reinforced in *Parkes Management Limited v Perpetual Trustee Co & Pty Limited*,[5] where Hope JA said:

> "The appointment of a trustee is understandably required by statute in these cases as a safeguard to ensure that the interests of the unitholders are maintained, but the manager also had this obligation, and in a sense also supervised the activities of the trustee."

Where a fiduciary duty does exist, it will impose a stringent duty on managers (over and above that which the Corporations Law may impose) not to permit a conflict of duty and interest and not to profit from their position (except to the extent agreed).

An example might illustrate the impact of the possible application of fiduciary obligations to fund managers.

Assume A manages funds for Pension Fund No 1 in circumstances where A owes fiduciary duties to the beneficiaries of Pension Fund No 1. If A is offered an allocation of securities in a placement at a very favourable price, A may well be obliged to allocate the securities to Pension Fund No 1 before allocating any of those securities to a pension fund maintained for the benefit of employees of A's company. This might flow from A's fiduciary duty to achieve the best result from Pension Fund No 1 and A's obligation not to prefer its own interests to those of the beneficiaries of Pension Fund No 1.

Examples could be multiplied, but I believe the point has been made.

Let us now turn to some of the other key legal constraints on the conduct of business by funds managers.

CONTRACTUAL OBLIGATIONS

The terms of the contract pursuant to which a fund manager manages funds are, in some circumstances, controlled by statute. For instance, as Keith Nathan's paper points out, the Superannuation Industry (Supervision) Act deems certain covenants to be included in the governing rules of a superannuation entity and in superannuation trust deeds. Section 1069 of the Corporations Law similarly requires the inclusion of certain provisions in the trust deeds governing public unit trusts.

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4 (1985) 9 ACLR 926.

5 (1977) ACLC 29,545 at 29,551.

The contractual framework of relationships in financial services or funds management is, subject to statutory restrictions of the sort just described, infinitely various. However, a number of matters commonly dealt with by contracts should be noted:

- does the contract impose a duty of care? If so, to what standard?
- does the contract impose confidentiality obligations, eg that the manager is not to disclose positions of the fund or its intentions?
- does the contract limit or disclaim liability for negligent advice?
- does the contract permit the manager to have conflicting positions (whether for other clients or on its own account)?
- does the contract limit any fiduciary relationship which might otherwise exist?[6]
- does the contract attempt to deal in any way with some of the more difficult issues that arise, eg allocation of securities as between different funds or the ability of a fund manager to take positions for its own account in securities in which the fund has a position?

There is little more which can be said of a general nature about contractual duties and obligations in a paper of this kind. Suffice it to say that it is possible for funds managers to limit their risk and obligations in appropriate circumstances and they should consider doing so.

CORPORATIONS LAW DUTY OF HONESTY AND NOT TO ABUSE INFORMATION OR POSITION - SECTION 232

Section 232 of the Corporations Law, as is well known, imposes in sub-section (2), a duty to act honestly on officers of corporations ("officer" in this case including directors, secretaries or executive officers, as well as some others such as receivers).

The section goes on in following sub-sections to impose on "officers" or "**employees**" (note, not just officers) of corporations an obligation:

- not to make improper use of information acquired by virtue of his or her position as such an officer or employee to gain, directly or indirectly, an advantage for himself or herself or for any other person, or to cause detriment to the corporation (sub-section (5)); and
- not to make improper use of his or her position as such an officer or employee to gain, directly or indirectly, an advantage or himself or herself or for any other person, or to cause detriment to the corporation (sub-section (6)).

The prohibition in sub-section (5) on improper use of information, is a provision which supplements insider trading laws. There will be many circumstances in which this catch-all prohibition limits the conduct of dealers in financial services or funds management business. The prohibition in sub-section (6) on improper use of position is also potentially of far-reaching application in relation to funds management.

For instance, let us turn to the situation where a rare and prized allocation of shares in a new float is made available to the employee of a funds management organisation by a stockbroker,

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6 See the comments of Mason J in *Hospital Products* at page 97: "That contractual and fiduciary relationships may co-exist between the same parties has never been doubted ... In these situations, it is the contractual foundation which is all important because it is the contract that regulates the basic rights and liabilities of the parties. The fiduciary relationship, if it is to exist at all, must accommodate itself to the terms of the contract so that it is consistent with, and conforms to, them."

because that employee pushes brokerage business to the stockbroker. Is this an improper use of position by the employee of the funds manager?

Or assume that the employee of a funds management organisation becomes aware, in his or her capacity as a funds management employee, that a particular company is in financial difficulty. The employee uses the information to decide not to convert convertible notes the employee holds for his personal account in the sick company. Instead the employee allows the notes to mature and is repaid just ahead of a significant fall in the share price of the relevant company. This would not be a breach of insider trading legislation, since the insider trading legislation does not prohibit the use of information to decide **not** to deal. However, it might be a breach of section 232(6) if (and perhaps this is a "big if") the employee would otherwise have converted the notes to shares.

The general prohibitions in section 232 might also be used to strike at "front-running" in other circumstances where the front-running does not amount to a use of "inside information" (eg because the information may not have had a **material** effect on the price or value of securities.)

INSIDER TRADING LEGISLATION

As is well known, Division 2A of Part 7.11 of the Corporations Law contains comprehensive prohibitions on insider trading.

I do not propose, in this short paper, to attempt to cover ground already dealt with at length by many others.[7]

However, let me note two oddities.

The first is that insider trading legislation prohibits an insider (a person in possession of material non-public price sensitive information) from dealing in securities or procuring another to do so (section 1002G(2) of the Corporations Law). It also prohibits the insider from communicating inside information in relation to listed securities in certain circumstances (see section 1002G(3)). However, as has been noted above, it does not breach insider trading legislation to use inside information to reach a decision **not** to deal in securities.

The second oddity, which may have particular relevance in a funds management context, is the so-called "own intentions" exception in favour of bodies corporate contained in section 1002Q of the Corporations Law. This provides that a body corporate does not breach section 1002G(2) (but note, not section 1002G(3)) if it deals in securities at a time at which it has knowledge of its own intention to purchase further securities.

The intention of this exception was to stop the absurd situation arising that it might be said that a body corporate, which intended to make a takeover offer for a company, was prohibited from purchasing securities in the target prior to the making of the takeover offer because its knowledge of its own intentions to make a takeover offer was price sensitive.

Whilst one can forgive the draftsmen for not foreseeing all situations, the exception does not achieve the intention of the legislature when applied to the situation of a body corporate which acts as the funds manager of a number of funds. Assume a company, Funds Manager Limited, is

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7 See, for example, Ford and Austin, *Principles of Corporations Law* (Sixth Edition, 1991); the Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *"Fair Shares for All: Insider Trading in Australia"*, (October 1989); M Ziegelaar, "Insider Trading Law in Australia" in *Securities Regulation in Australia and New Zealand*, edited by Walker and Fisse, Oxford University Press (1994), to name just some of the many contributions in this area.

manager to Pension Fund A and Pension Fund B. Pension Fund A is an extremely large fund, whose dealings are frequently large enough to afford the market price of securities.

Assume Funds Manager Limited intends, in its capacity as manager of Pension Fund A, to buy a large number of securities in a small thinly traded stock. The knowledge of that intention is price sensitive information. If Funds Manager Limited uses that knowledge to buy shares in the thinly traded stock for Pension Fund B (or, even worse, for its own account), before "getting set" for Pension Fund A, that however may well attract the "own intentions" exception. The "own intentions" exception does not distinguish between dealings on one's own account and dealings as trustee or manager for others. Accordingly, insider trading prohibitions may not apply in this situation even though the action falls clearly within the scope of the vice the insider trading provisions were designed to avoid.

The situation just given may be one where the relevant action is a breach of section 232 of the Corporations Law or of a fiduciary or contractual obligation owed to Pension Fund A. It may also be a breach of the fund manager's duty, as the holder of a securities dealer's licence, to act efficiently, honestly and fairly (see below). However, the provisions which should apply in these situations are the insider trading provisions and it seems to me the position deserves legislative attention.

CLIENT PRIORITY RULES

Section 844 of the Corporations Law contains a limited statutory requirement for securities dealers to give priority to clients' orders. In broad terms, it prohibits a securities dealer from buying or selling listed securities on its own behalf or on behalf of its associates in circumstances where it has an as yet unfulfilled order from a client to deal in the same securities. (An exception exists where the client's order is subject to a price or other condition which has not yet been fulfilled.)

Note that the provision does not amount to a general statutory requirement for securities dealers or funds managers to give priority to client orders. Specifically, the provision only applies to listed securities and only applies where a client of a dealer has given an instruction to the dealer to deal in securities which has not yet been fulfilled. Funds managers frequently do not receive instructions to deal in securities from clients at all, but rather act of their own motion.

It follows that where a funds manager has discretionary power from clients and never acts on clients' instructions, it may never be bound by section 844.

Thus, section 844 would present no barrier to a funds manager purchasing securities for its own account before purchasing for its discretionary clients (or purchasing for favoured discretionary clients before purchasing for less favoured discretionary clients). Again, there might be other restraints on such behaviour, eg fiduciary or contractual obligations or the obligation of a licence holder to act efficiently, honestly and fairly. However, the point is that the statutory provision specifically designed to curb this kind of "front-running" does not achieve its purpose.

The client priority rules applicable to securities dealings should be contrasted with the detailed allocation and priority rules applicable to futures trading under section 1266 of the Corporations Law (although again these provisions presuppose the giving of instructions).

It should also be pointed out that the Australian Stock Exchange Business Rules, Rule 3.3 requires a member of the Australian Stock Exchange to advise its clients of the policy it adopts in allocation of securities. This of course does not require the broker to adopt any particular policy. Further, this provision only binds members of the Australian Stock Exchange and few funds managers are member of the Australian Stock Exchange (although many have related corporations which are members of the Australian Stock Exchange).

FEE AND BENEFIT DISCLOSURE

Section 849 of the Corporations Law imposes on securities dealers and investment advisers a duty to make disclosure of any commissions, fees or other benefits or advantages which the securities dealer or investment adviser might receive in consequence of making a recommendation about securities to a client. The provision only applies where the recommendation is made to a client who might reasonably be expected to rely on it.

This raises a number of interesting questions in the funds management context. For instance, does a funds manager with discretion to buy on behalf of managed funds make "recommendations"? Depending on the structure of the relationship between the funds manager and any trustee, an implied (and perhaps an express) recommendation may well be involved.

If so, the stringent fee and benefit disclosure provisions of section 849 may well act as a de facto fiduciary obligation.

For instance, if a fund manager could derive any benefit from making a recommendation to a client that it buy or sell securities, section 849 will effectively require it to give full information to the client. Section 849 does not go as far as requiring the kind of fully informed consent which would excuse breaches of fiduciary duty, but it is a near relative to it.

Take this situation. The corporate advisory arm of a full service financial institution is advising a raider which is attempting to make a takeover offer for a listed company. Its related funds manager makes "recommendation" to trustees of funds that it manages that they sell to the bidder. Failure to disclose any benefits derived by the corporate advisory arm under section 849 will expose the funds manager to a breach of section 849 and possible damages claims under section 852.

KNOW YOUR CLIENT AND KNOW YOUR PRODUCT RULE

Section 851 of the Corporations Law requires that any securities adviser who makes recommendations about securities to a person who may reasonably be expected to rely on it, must have a reasonable basis for making the recommendation.

A securities adviser is deemed not to have a reasonable basis for making a recommendation unless the securities adviser has given such consideration to the subject matter of the recommendation as is reasonable in all the circumstances, having regard to what the adviser knows about the client's investment objectives, financial situation and particular needs.

The ASC interprets this provision as a "know your client and know your product" rule.[8]

The ASC interpretation imposes obligations on securities advisers which, in my view, cannot be found in the words of section 851 themselves. However, there seems no doubt that section 851 requires those who make recommendations to clients about securities (as to which see above) to have some reasonable basis for making them.

This may well amount to a statutory duty of care on funds managers in many situations.

Breach of section 851 gives rise to an action for damages under section 852.

It seems to me that the importance and potential scope statutory damages action created by section 852 has been largely overlooked. I expect it to be used more in future.

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8 See paragraph 5.4 of the *Australian Securities Commission Licensing Review Report into Investment Advisory Services "Good Advice"* November 1995.

LICENCE CONDITIONS - ACTING EFFICIENTLY, HONESTLY AND FAIRLY

One cannot obtain a securities dealer's licence unless the ASC is satisfied that the applicant will act "efficiently, honestly and fairly" (see section 784 of the Corporations Law). Similarly, failing to act efficiently, honestly and fairly will be a ground for revocation of the securities dealer's licence (section 826).

The "efficient, honest and fair" requirement is the ASC's key tool for ensuring licensees behave properly. It is clear, both from the ASC's published statements and from judicial decisions, that the phrase covers conduct which is "morally wrong in a commercial sense", though not a breach of the law or a condition of the licence.[9]

Most importantly the ASC will certainly use the "efficient, honest and fair" requirement to enforce commercial morality in financial services and funds management businesses. The power and flexibility of this weapon in the hands of the ASC should not be underestimated.

CONCLUSION

The stock-in-trade of the banking lawyer, and the banker, will change. Tomorrow's banker and banking lawyer will need to master all (or at least most) of the knowledge of today's banking lawyer but more besides. The laws governing securities, futures and derivatives, and the conduct of those who deal in them, will become part of the repertoire of the practising banking adviser.

This paper has, hopefully, pointed to some of the areas to be conquered by those attending this conference in future years.

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9 See *R J Elrington Nominees Pty Ltd v CAC* (1989) 1 ACSR 93; *Story v NCSC* (1988) 13 ACLR 225; and *Nisic v CAC* (1990) 8 ACLC 514.