

FIDUCIARY DUTIES AND REGULATORY RULES



LAW COMMISSION
LAW COM No 236

LAW COMMISSION



The Law Commission

(LAW COM No 236)

FIDUCIARY DUTIES AND REGULATORY RULES

**REPORT ON A REFERENCE UNDER SECTION
3(1)(e) OF THE LAW COMMISSIONS ACT 1965**

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by Command of Her Majesty
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The Law Commission was set up by section 1 of the Law Commissions Act 1965 for the purpose of promoting the reform of the law.

The Commissioners are:

The Honourable Mr Justice Brooke, *Chairman*
Professor Andrew Burrows
Miss Diana Faber
Mr Charles Harpum
Mr Stephen Silber QC

The Secretary of the Law Commission is Mr Michael Sayers and its offices are at Conquest House, 37-38 John Street, Theobalds Road, London, WC1N 2BQ.

The terms of this report were agreed on 1 November 1995.

THE LAW COMMISSION

FIDUCIARY DUTIES AND REGULATORY RULES

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GLOSSARY OF ABBREVIATIONS

In this report the following terms and expressions are used for the sake of brevity:

“BMBA”	British Merchant Banking and Securities Houses Association (now the London Investment Banking Association)
“Company Law Committee”	The Law Society's Standing Committee on Company Law
“DTI”	Department of Trade and Industry
“FIMBRA”	Financial Intermediaries, Managers and Brokers Regulatory Association
“FSA”	Financial Services Act 1986
“IMRO”	Investment Management Regulatory Organisation Limited
“ISD”	Investment Services Directive, Council Directive 93/22/EEC (OJ L141, 11.6.93, p 27)
“the Large Report”	the report by Mr Andrew Large called <i>Financial Services Regulation - Making the Two Tier System Work</i> (May 1993)
“LAUTRO”	Life Assurance and Unit Trust Regulatory Organisation
“PIA”	Personal Investment Authority
“RPB”	Recognised Professional Body, ie a body which regulates the practice of a profession and is recognised by the Secretary of State under FSA, section 18
“SFA”	The Securities and Futures Authority Limited
“SIB”	The Securities and Investments Board
“SRO”	Self-Regulating Organisation recognised by the Secretary of State under FSA, section 10
“UCTA”	Unfair Contract Terms Act 1977
“UTCCD”	Unfair Terms in Consumer Contracts Directive, Council Directive 93/13/EEC (OJ L95, 21.4.93, p 29)

Cases

“ <i>El Ajou</i> ”	<i>El Ajou v Dollar Land Holdings plc</i> [1994] 2 All ER 685; the decision of Millett J at first instance is reported at [1993] 3 All ER 717
“ <i>Meridian</i> ”	<i>Meridian Global Funds Management Asia Ltd v The Securities Commission</i> [1995] 2 AC 500

“Kelly”

Kelly v Cooper [1993] AC 205

“Clark Boyce”

Clark Boyce v Mouat [1994] 1 AC 428

“Glynwill”

Glynwill Investments NV v Thomson McKinnon Futures Ltd 13 February 1992 (unreported, Tuckey QC)

“Target Holdings”

Target Holdings Ltd v Redferns [1995] 3 WLR 352

THE LAW COMMISSION

(Report on a reference to the Law Commission under Section 3(1)(e) of the Law Commissions Act 1965)

FIDUCIARY DUTIES AND REGULATORY RULES

To the Right Honourable the Lord Mackay of Clashfern, Lord High Chancellor of Great Britain

SECTION A INTRODUCTION

PART I INTRODUCTION AND SUMMARY OF MAIN RECOMMENDATIONS

Terms of reference

- 1.1 In April 1990 a reference was made to the Law Commission by the Minister for Corporate Affairs in the following terms:

Certain professional and business activities are subject to public law regulation by statutory and self-regulatory control. The Law Commission is to consider the effect of such controls on the fiduciary and analogous duties of those carrying on such activities, and to make recommendations. The inquiry will consider examples from differing areas of activity but will be with particular reference to financial services.

A parallel reference was made to the Scottish Law Commission.

Background

- 1.2 Situations in which professionals and businesses appear to owe conflicting duties to different customers or in which there is a conflict between their own interests and those of their customers are not new. However, the potential for such conflicts increased as a result of the changes to the structure of the financial markets in the mid-1980s, in particular the abolition of the Stock Exchange's single capacity requirement and the development of financial conglomerates offering a wide range of services.
- 1.3 Our legal system primarily deals with such conflicts by treating the relationship between the provider and recipient of such services as giving rise to fiduciary duties on the part of the provider and conferring on the recipient rights of action for breach of the obligations imposed on the provider. Broadly speaking, a fiduciary relationship is one in which a person undertakes to act on behalf of or for the benefit of another, often as an intermediary with a discretion or power which affects the interests of the other who depends on the fiduciary for information and advice.

1.4 The exact scope of the fiduciary's obligations and the consequences of breach vary according to the particular circumstances but the duties may conveniently be summarised in the following basic rules:

- (i) **the "no conflict" rule** A fiduciary must not place himself in a position where his own interest conflicts with that of his customer, the beneficiary. There must be a "real sensible possibility of conflict";¹
- (ii) **the "no profit" rule** A fiduciary must not profit from his position at the expense of his customer, the beneficiary;
- (iii) **the undivided loyalty rule** A fiduciary owes undivided loyalty to his customer, the beneficiary, not to place himself in a position where his duty towards one customer conflicts with a duty that he owes to another customer. A consequence of this duty is that a fiduciary must make available to a customer all the information that is relevant to the customer's affairs;²
- (iv) **the duty of confidentiality** A fiduciary must only use information obtained in confidence from his customer, the beneficiary, for the benefit of the customer and must not use it for his own advantage, or for the benefit of any other person.

1.5 Conflicts of interest and duty which could breach these obligations are most common in financial services conglomerates because of the range of services they provide, the composition of their customer base, and the different capacities in which they conduct business. Problems arise in particular because, even if there is functional segregation within the firm, knowledge possessed in one part of a single corporate entity or partnership is treated in law as known to all parts of that entity (the attribution of knowledge rule). Even where the conglomerate is not a single corporate entity problems may arise where, as is often the case, some directors sit on the boards of both the parent and a subsidiary company.

1.6 Examples of the types of conflict that can arise include dealing off one's book or buying on one's own account, matching orders ("agency cross"), buying from a customer and selling immediately to another customer ("riskless principal" transactions), dealing in property in which the customer has an interest, preferential or discriminatory treatment in, for example, the allocation of investment

¹ *Boardman v Phipps* [1967] 2 AC 46, 124, *per* Lord Upjohn.

² Although there are limits on the obligation to use *all* relevant information; see paras 3.26, 3.35 below.

opportunities and failure to use all the information which the attribution of knowledge rule deems to be available to a firm.³

- 1.7 The Financial Services Act 1986 introduced a new system for the regulation of firms providing financial services. At the time of its enactment there was considerable discussion of the relationship between the new regulatory system and the fiduciary obligations described above. It was concern over the possible mismatch between the duties imposed on fiduciaries at common law and in equity and the requirements of the regulatory system introduced by the FSA which led this matter to be referred to the Law Commission. However, although the report looks principally at the financial services industry the terms of reference include all areas subject to statutory and other forms of public law regulation.

Consultation paper

- 1.8 We published a consultation paper in May 1992.⁴ Our provisional conclusion was that although instances where regulatory rules *require* firms to act in a manner which would breach their fiduciary duties are rare, there are many instances where regulatory rules *permit*, either expressly or impliedly, a lower standard of conduct than that required by fiduciary law. We identified the following main areas of potential mismatch between fiduciary obligations and regulatory rules:⁵

- (i) disclosure of commission (including “soft” commission) and other remuneration;⁶
- (ii) relaxation of the “no profit” rule;⁷
- (iii) the operation of Chinese walls.⁸

³ For an explanation of these and other types of conflict which can arise, see Consultation Paper No 124, para 2.4.12.

⁴ Fiduciary Duties and Regulatory Rules, Consultation Paper No 124.

⁵ Consultation Paper No 124, para 1.13.

⁶ For example, under “soft commission” arrangements a broker/dealer provides goods or services to a fund manager in return for a guarantee that the manager will provide it with a specified minimum amount of business. These arrangements give rise to conflicts between the manager’s interests and those of its customers and the disclosure contemplated by the IMRO and SFA rules (see IMRO Rule 1.7, SFA Rule 5-8) may fall short of that required by common law and equity in relation to certain types of customer. See paras 2.13-2.15 below.

⁷ For example, the regulatory rules envisage that when a broker receives instructions from a client to purchase stock it may purchase it from a market maker within its own organisation or it may sell off its own book (eg SIB Core Conduct of Business Rules 2, 24). This could constitute a breach of the “no profit” rule.

⁸ A number of regulatory rules authorise or require firms to put in place mechanisms for preventing the flow of information between different parts of their business (eg SIB Core Rule 36, SFA Rule 5-3, IMRO Chap I Rule 4.2). Prima facie, these are inconsistent with the obligation owed by firms to make available to their customers all the relevant

1.9 In the consultation paper we examined how this potential mismatch was, or could be, resolved as the law stood. We considered three particular aspects to this.

(i) First, we looked at *contractual techniques*⁹ for avoiding potential breaches of duty. We considered:

(a) whether regulatory rules and market practices could be incorporated into contracts as trade customs;

(b) how far exclusion clauses could modify rights against fiduciaries; and

(c) whether it was possible or practicable to obtain sufficiently informed consent by advanced disclosure in contracts to modify or displace the fiduciary's duties.

(ii) Secondly, we looked at *structural techniques* for managing conflicts and in particular the use of Chinese walls.

(iii) Thirdly, we looked at the *public law dimension* and considered how far the regulatory system could be taken to have modified the common law and equitable duties.

1.10 We concluded, provisionally, that the contractual and structural methods could not safely be relied on in all cases but that a court would probably take into account reasonable regulatory rules in determining the content of the fiduciary obligation. Nevertheless, given the uncertainty on this latter point, we inclined to the view that there should be legislation to resolve the position.

Subsequent developments

1.11 Since the publication of the consultation paper there have been a number of legal and regulatory developments.¹⁰ The case of *Kelly v Cooper*¹¹ has been of particular importance. It examined the scope of fiduciary duties and the impact of express and implied terms on those duties. It confirmed that where a fiduciary relationship arises out of a contract, a clearly worded duty defining or exclusion clause will circumscribe the extent of the fiduciary duties owed to the other party. There have

information in their possession.

⁹ These were said to be arrived at by the agreement of the parties. See Consultation Paper No 124, para 3.1.1.

¹⁰ For a detailed discussion of these developments, see Parts III-V below.

¹¹ [1993] AC 205. See paras 3.24-3.36 below.

also been significant changes to the regulatory structure as a result of the implementation of the Large Report, which was published in May 1993.¹²

The consultation

- 1.12 104 individuals and organisations responded to the consultation paper. The responses were fairly evenly split between members of the legal profession (judges, barristers, solicitors, academics and representative bodies) and those in the commercial field (including banks, financial institutions, accountants, representative and regulatory bodies). A list of respondents appears at Appendix E. The responses revealed a substantial degree of concern about our provisional conclusions on the effectiveness of contractual and structural techniques in avoiding and modifying a firm's fiduciary duties to its customers although only a minority of those disagreeing with the provisional conclusions felt that reform was in fact unnecessary. Following the case of *Kelly*, however, a number of consultees who had previously favoured reform indicated that they were now more confident that the use of contractual techniques would avoid any problems and indeed some indicated that they no longer considered reform to be necessary. The responses to the consultation paper confirmed that problems arising from mismatch between regulatory rules and fiduciary duties outside the financial services area were rare.

The Oxford seminar

- 1.13 In November 1993 together with The Securities and Investments Board ("the SIB") we held a seminar at Merton College, Oxford to assess the impact of the recent legal and regulatory developments and to consider what options for reform were realistic in the light of these developments and the responses which we had received on consultation. This seminar was attended by representatives of the Treasury, the SIB, The Law Society's Standing Committee on Company Law ("the Company Law Committee"), the British Merchant Banking and Securities Houses Association (now the London Investment Banking Association)("the BMBA") and the Bank of England. A list of those present appears at Appendix F. It proved particularly useful in enabling us to identify the common ground between the different parties with an interest in the financial services sector. We have continued to discuss developments with representatives of the organisations present at the Oxford seminar and many others have also made valuable contributions to this project. They are listed in Appendix G.

Recommendations

- 1.14 In the light of the responses to our consultation paper, and the legal and regulatory developments since its publication, we have decided not to proceed with our provisional recommendation that there should be legislation requiring a court to take account of reasonable regulatory rules in determining the content of a fiduciary

¹² For a description of this report, see paras 5.2-5.4 below.

obligation.¹³ We have also decided not to recommend, in this report, the introduction of an exculpatory provision for fiduciaries along the lines of section 61 of the Trustee Act 1925, which was one of the other options for reform canvassed in our consultation paper.¹⁴

1.15 However, we do recommend that there should be legislation to clarify the effect of Chinese walls, which are widely used by firms operating in the financial services sphere to manage or avoid conflicts of interest and duty. We propose that the effect of section 48(2)(h) of the Financial Services Act 1986 should be clarified so as to give statutory protection to a firm which operates an established Chinese wall arrangement which complies with rules made by the SIB under that subsection. The firm should be protected from liability where:

- (i) information is withheld from a customer (or is not made available for the customer's use) pursuant to the Chinese wall arrangement;
- (ii) a firm places itself in a position where its own interest on one side of the Chinese wall conflicts with a duty owed to the customer of a department on the other side of the Chinese wall and as a result of the Chinese wall neither department is aware of the conflict; or
- (iii) a firm owes conflicting duties to the customers of different departments on different sides of the Chinese wall, and as result of the Chinese wall neither department is aware of the conflict.¹⁵

Structure of the report

1.16 In Section B (Parts II-V) of this report we consider the legal and regulatory developments which have taken place since the date of publication of the consultation paper and examine how they affect our provisional conclusions. We take the opportunity in this section to summarise our provisional views, expressed in the consultation paper, on the issue of acquisition of knowledge by a firm and on the effectiveness of contractual techniques and Chinese walls (as a matter of private law)¹⁶ in dealing with the potential mismatch between regulatory rules and fiduciary

¹³ See Part XIV below.

¹⁴ See Consultation Paper No 124, para 6.28. See Part XV below.

¹⁵ See Part XVI below.

¹⁶ The discussion on Chinese walls involves consideration of the position as a matter of private law and public law. The summary in Section B concentrates on the private law position as it is in this respect that there have been relevant legal developments. A summary of our provisional views on the effectiveness of Chinese walls as a matter of public law is contained in Section C where we consider respondents' views on the relevant issues.

duties.¹⁷ Section C (Parts VI-XII) considers the issues arising from consultation and respondents' views on the impact of recent developments. Our final conclusions and recommendations for reform are set out in Section D (Parts XIII-XVIII). Our recommendations are summarised in the final part of that section (Part XVIII).

Acknowledgements

- 1.17 We are grateful to all those who commented on our consultation paper and to all those who generously assisted us in subsequent correspondence and discussions. We are also grateful to Professor Caroline Bradley, of the University of Miami, who gave us valuable assistance with the preparation of the consultation paper. We would like to express our particular thanks to Professor D D Prentice of the University of Oxford who acted as our consultant throughout this project.

¹⁷ A summary of our provisional views on the general impact of the regulatory system on common law and equitable duties as a matter of public law is included in Section D where we set out our final conclusions and recommendations.

SECTION B LEGAL AND REGULATORY DEVELOPMENTS

PART II INTRODUCTION AND SUMMARY OF PROVISIONAL VIEWS ON ACQUISITION OF KNOWLEDGE, CONTRACTUAL TECHNIQUES AND CHINESE WALLS

Introduction

- 2.1 There have been a number of legal and regulatory developments since the date of publication of the consultation paper. In this section of the report we examine these developments and assess their impact on our provisional conclusions. In Part III we consider developments in the case law and examine the cases of *El Ajou*, *Meridian*, *Kelly*, *Clark Boyce*, and *Glynwill*. In Part IV we deal with new directives, statutes and regulations and in particular the Directive on Unfair Terms in Consumer Contracts,¹ the Investment Services Directive,² and Part V of the Criminal Justice Act 1993. In Part V we consider the regulatory developments arising from the Large Report, the recognition of the Personal Investment Authority ("the PIA"), and the changes to the rules on disclosure of commission.³
- 2.2 Before turning to these legal and regulatory developments we summarise, in the remainder of this part, the provisional views we expressed in the consultation paper on the issues to which these developments relate. We consider in turn: first, the acquisition of knowledge by a firm; secondly, the extent to which what were termed "contractual techniques"⁴ can resolve conflicts of interest and duty, or conflicts between the duties owed to two customers, so as to avoid a mismatch between fiduciary obligations and what is required or permitted by regulatory rules; and thirdly, the effectiveness of Chinese walls (as a matter of private law)⁵ as a means of eliminating or minimising conflicts.⁶

¹ Council Directive 93/13/EEC (OJ L95, 21.4.93, p 29).

² Council Directive 93/22/EEC (OJ L141, 11.6.93, p 27).

³ The Financial Services (Conduct of Business) (Product and Commission Disclosure) Rules 1994.

⁴ See para 1.9, n 9 above.

⁵ A summary of our provisional views on the effectiveness of Chinese walls as a matter of public law is set out in paras 7.19-7.30 below.

⁶ Our provisional views on the impact, as a matter of public law, of regulatory rules on the common law and equitable rights and obligations of those subject to them and their customers are summarised in Part XIV. The consultation paper also considered the effectiveness in legal and practical terms of policies of enforced separation (section 4.2), the placing of specific prohibitions on particular types of acute conflict (section 4.3) and independence policies (section 4.4).

Acquisition of knowledge by a firm⁷

- 2.3 In the consultation paper we said that there were two different means by which knowledge could be acquired by a company.⁸ The first was to attribute directly to the company the knowledge possessed by one of its officers or agents. There were two broad approaches to this.⁹ One was the “functional” approach which involved determining the purpose of a finding of knowledge on the part of the company and from this “tailoring to the purpose in hand the net of human persons whose knowledge will be ascribed to the company”.¹⁰ The other sought to identify who was the “brain or nerve centre” of the company and attributed the knowledge of that person to the company.¹¹
- 2.4 The second means by which knowledge could be acquired by a company was under standard principles of agency. We said that a company, as principal, would usually be treated as possessing all the knowledge that is possessed by its officers and agents which it was their responsibility to receive on behalf of the company and to communicate to it. This meant that as regards any particular act or transaction the company would be deemed to know the information acquired by its agents or officers within the scope of their authority in connection with that act or transaction.¹²
- 2.5 We said that a company would only be treated as having “forgotten” a piece of relevant information in exceptional circumstances.¹³ We also stated that any matter known by any part of the company would be treated as known by all parts of the company.¹⁴ However, as companies are separate legal entities, knowledge possessed by one company which was part of a group would not be attributed to another company in the same group.¹⁵ But we also said that the knowledge acquired by a person when acting as a director of one company within a group could be attributed to another company within the group if the director was under an obligation to communicate the information to that other company.¹⁶

⁷ Consultation Paper No 124, section 2.3. This expression is used to include partnerships and companies.

⁸ Consultation Paper No 124, para 2.3.2.

⁹ *Ibid*, para 2.3.3.

¹⁰ Wedderburn, “When does a Corporation Forget?” (1984) 47 MLR 345, 345.

¹¹ *Ibid*, at p 346. See now, however, paras 3.15-3.23.

¹² Consultation Paper No 124, para 2.3.4.

¹³ *Ibid*, para 2.3.5.

¹⁴ *Ibid*, paras 2.3.6-2.3.7.

¹⁵ *Ibid*, para 2.3.8.

¹⁶ *Ibid*, para 2.3.9.

2.6 So far as partnerships are concerned, we said that notice to one partner of any matter relating to the affairs of the partnership would normally be imputed to the other partners, although a number of cases appeared to qualify the breadth of this rule where a firm had established arrangements to prevent knowledge from being communicated from one partner to others within the firm.¹⁷

Contractual techniques

2.7 The three contractual techniques considered in the consultation paper were first, trade custom and rules of practice; second, exclusion clauses; and third, disclosure and consent.

*Trade custom and rules of practice*¹⁸

2.8 In the consultation paper we explained that a course of conduct might constitute a trade custom if four conditions were satisfied. The first was that there was a course of conduct; the second, that the course of conduct was certain and uniform; the third that it was notorious; and the last that it was intended to be legally binding, rather than being followed merely as a matter of convenience or commercial exigency.¹⁹

2.9 We said that, in general, there would be little difficulty in proving that the rules of regulatory bodies satisfied the factual requirements of trade customs.²⁰ However, once it had been established that a regulatory rule fulfilled the requirements of a trade custom, it would only be incorporated into the contract if it was reasonable.²¹ A custom which modified a firm's fiduciary duty would usually be held unreasonable and would not, therefore, bind the customer in the absence of his fully informed consent.²² However, we suggested that there was a possibility that a trade custom which permitted a fiduciary to act in a position of conflict might be held reasonable if the custom provided adequate protection for the customer's interests, for example, by fixing a fair price at which orders were to be matched.²³

2.10 We provisionally concluded that, although the courts might adopt the latter approach, English courts tended to favour the approach that conflicts of interest and duty were incompatible with the position of a fiduciary. It was, therefore, our

¹⁷ *Ibid*, para 2.3.10.

¹⁸ *Ibid*, section 3.2.

¹⁹ *Ibid*, paras 3.2.2-3.2.7.

²⁰ *Ibid*, paras 3.2.11-3.2.12.

²¹ *Ibid*, para 3.2.13.

²² *Ibid*, para 3.2.16; *Anglo-African Merchants Ltd v Bayley* [1970] 1 QB 311.

²³ Consultation Paper No 124, para 3.2.17-3.2.22; *North and South Trust Co v Berkeley* [1971] 1 WLR 470; *Jones v Canavan* [1972] 2 NSWLR 236.

provisional view that a custom which permitted a fiduciary to act in a conflict situation was unlikely to be upheld.²⁴

*Exclusion clauses*²⁵

2.11 We stated in the consultation paper that a fiduciary could not exclude liability for fraud, deliberate breach of duty and, possibly, gross negligence.²⁶ Beyond that, our provisional view was that, in general, no restrictions operated as a matter of fiduciary law to prevent a fiduciary from contracting out of or modifying his fiduciary duties, particularly where no prior fiduciary relationship existed and the contract sought to define the duties of the parties.²⁷ This was because we considered that the court would have regard to all the terms of the contract or instrument when determining whether a relationship was fiduciary and, if so, the scope of the fiduciary's duties.²⁸

2.12 However, we noted that in determining whether a relationship was fiduciary, and if so, the extent of the fiduciary duties, a court would look at the substance of a relationship and not merely its description in the contract. Thus, a statement in a contract that, for example, a dealer is acting as principal would not be conclusive.²⁹ We also pointed out that for an exclusion clause to be effective, it would have to be clearly and unambiguously expressed since it would be strictly construed against the person who sought to rely on it; ie *contra proferentem*.³⁰ Finally, we said that such a clause would be subject to the controls imposed by the Unfair Contract Terms Act 1977, where applicable. The application of UCTA is examined in detail in the consultation paper, and we do not propose to repeat it here.³¹

*Disclosure and consent*³²

2.13 We explained in the consultation paper that fiduciary duties could be modified or displaced if the consent of the person to whom a duty was owed was obtained after

²⁴ Consultation Paper No 124, para 3.2.24.

²⁵ *Ibid*, section 3.3.

²⁶ *Ibid*, paras 3.3.5-3.3.7, 3.3.13.

²⁷ *Ibid*, para 3.3.13.

²⁸ *New Zealand Netherlands Society 'Oranje' Incorporated v Kuys* [1973] 1 WLR 1126; *Jirma Ltd v Mister Donut of Canada Ltd* [1975] 1 SCR 2; *Molchan v Omega Oil & Gas Ltd* [1988] 1 SCR 348. See Consultation Paper No 124, paras 3.3.10-3.3.13.

²⁹ Consultation Paper No 124, para 3.3.12(iii).

³⁰ *Ailsa Craig Fishing Co Ltd v Malvern Fishing Co Ltd* [1983] 1 WLR 964, 966, *per* Lord Wilberforce; Consultation Paper No 124, paras 3.3.14-3.3.17. However we noted that the strict construction rule did not apply to duty defining clauses which prevent a duty from arising or modify a duty so that there is no breach of contract; *ibid*, para 3.3.15.

³¹ Consultation Paper No 124, paras 3.3.24-3.3.38.

³² *Ibid*, section 3.4.

the making of full disclosure of all material facts.³³ The extent to which a duty was modified would depend on the extent of the disclosure and to what the beneficiary had consented. We said that in some situations it would be impossible to obtain sufficiently informed consent: where the matter in question was so complex and technical, the conflict so acute and the customer's understanding so limited that it would be impossible to place him in a position where he had adequate comprehension of the issues and consequences of giving a binding consent.³⁴ Beyond this we said that no matter how severe the conflict, if the customer fully understood the consequences of the fiduciary acting in the conflict situation his consent would be effective.³⁵ However, we concluded that it would often be impractical or impossible to divulge the requisite information in advance of the breach of duty, or at all.

2.14 We gave the example of a broker/dealer who might not know at the time of a particular transaction whether it was executed off its own book, and we said that where soft commission was taken it might be impossible to assess what part of the benefit received by the broker/dealer was attributable to the transactions carried out on behalf of the customer.³⁶ We said that if advanced disclosure could not be made, the firm had to bear the risk that the customer might choose not to consent, and that even if consent was obtained in advance, a conflict which was not predicted might subsequently arise, leaving the firm open to liability.

2.15 We thought it unlikely that the disclosure clauses in customer agreements would be able to cover all eventualities in sufficient detail. We also said that there was considerable doubt as to whether compliance with the disclosure requirements of the regulatory rules would satisfy general law requirements, for example, where a broker took soft commission.³⁷ We concluded that disclosure and consent were not a reliable means of avoiding mismatches between fiduciary law and what is required or permitted by the regulatory rules.

³³ *Ibid*, paras 3.4.1, 3.4.4-3.4.11. *Dunne v English* (1874) LR 18 Eq 524; *Parker v McKenna* (1874) LR 10 Ch App 96, 118; *Fullwood v Hurley* [1928] 1 KB 498; *Boardman v Phipps* [1967] 2 AC 46; *North and South Trust Co v Berkeley* [1971] 1 WLR 470. There are two exceptions to the rule requiring full disclosure: (i) where a broker sells to a customer off his own book and does not take commission on the sale it is sufficient for him to disclose that he is acting as principal; (ii) where in accordance with the usual practice of the business in which he is operating an agent receives remuneration from a third party in the form of a commission or discount and the principal is aware that the agent will be remunerated in this way, does not make further enquiry, and is not misled by the agent as to amount; Consultation Paper No 124, paras 3.4.6-3.4.10.

³⁴ Consultation Paper No 124, paras 3.4.17. SIB Principle 6 recognises that there may be circumstances in which it is appropriate to decline to act in a situation of conflict.

³⁵ Consultation Paper No 124, para 3.4.17.

³⁶ *Ibid*, paras 3.4.33-3.4.36, 3.4.26-3.4.28, 3.4.38.

³⁷ *Ibid*, para 3.4.28.

Chinese walls³⁸

2.16 In the consultation paper we stated that, broadly, Chinese walls were procedures for restricting flows of information within a firm to ensure that information which was confidential to one department was not improperly communicated (and this included inadvertent communication) to any other department within the conglomerate.³⁹ We said that a Chinese wall would provide protection against any allegation of breach of the duty of undivided loyalty where a customer had consented to the firm carrying on business using a Chinese wall as part of its organisational structure.⁴⁰ If consent was not obtained we said that a strong argument could be made that a Chinese wall designed to prevent a breach of the criminal law should protect a firm from allegations that it had failed to use relevant information on behalf of a customer. This was because a firm could not be expected to commit an illegality on behalf of any customer and, therefore, steps that were designed to prevent this from occurring would be legitimated to that extent. However, we said that it would still be arguable that if a firm had not obtained its customer's consent to the use of a Chinese wall it should have refused to act and avoided the conflict.⁴¹ We considered that the position was even less clear where there was a conflict between the interests of two customers and disclosure would not be a criminal act.⁴² Finally, we said that where there was a conflict between the interests of a firm and a customer, for example where a firm sold to a customer assets in which it had an interest, a Chinese wall was unlikely to provide protection.⁴³ We concluded that as a matter of private law the Chinese wall did not afford the type of protection that was needed for a firm to carry on its functions with the degree of assurance that the wall was designed to provide.⁴⁴

³⁸ *Ibid*, section 4.5.

³⁹ *Ibid*, para 4.5.1. We said that they normally involved some combination of (i) the physical separation of the various departments to insulate them from each other; (ii) an educational programme to emphasise the importance of not improperly or inadvertently divulging confidential information; (iii) strict and carefully defined procedures for dealing with the situation where the wall is crossed; (iv) monitoring by compliance officers of the effectiveness of the wall; (v) disciplinary sanctions where there has been an improper breach of the wall; *ibid*, para 4.5.2.

⁴⁰ *Ibid*, paras 4.5.1, 4.5.16.

⁴¹ *Ibid*, paras 4.5.17, 4.5.25.

⁴² *Ibid*, paras 4.5.17, 4.5.25.

⁴³ *Ibid*, paras 4.5.18, 4.5.25(iii).

⁴⁴ *Ibid*, para 4.5.25. For problems associated with wall crossing and management oversight of walls see *ibid*, paras 4.5.20-4.5.23.

PART III LEGAL DEVELOPMENTS - CASES

Introduction

- 3.1 In this part we examine the cases of *El Ajou v Dollar Land Holdings plc*¹ and *Meridian Global Funds Management Asia Ltd v The Securities Commission*² which concern the question of acquisition of knowledge by a company; and the cases of *Kelly v Cooper*,³ *Clark Boyce v Mouat*,⁴ and *Glynwill Investments NV v Thomson McKinnon Futures Ltd*⁵ which consider the role of contract in determining the scope of fiduciary duties.⁶

El Ajou

- 3.2 This case concerns the question of acquisition of knowledge by a company. It considers the two different means by which knowledge could be acquired, namely by direct attribution because of the position or status of the person within the company who has the knowledge and under the normal rules of agency.⁷ It addresses, in particular, the situation where a person who is an officer of two companies acquires knowledge while acting for one of them.
- 3.3 The claim was brought by the Plaintiff ("El Ajou") against the defendant ("DLH"), an English registered property development company, to recover moneys which he had lost as a result of a fraud perpetrated against him by three Canadians. DLH was not directly involved in the fraud but El Ajou asserted that it had acquired assets representing the proceeds of the fraud with knowledge of the fraud and was therefore liable to it under the knowing receipt head of constructive trust.
- 3.4 It was alleged that the knowledge had been acquired by DLH in the following way. The Canadians had been clients of a Swiss company, owned by a Mr Ferdman, which acted as a fiduciary agent for clients who did not wish their identities to be disclosed. Ferdman was also a non-executive director and chairman of DLH. He introduced the Canadians to DLH, and the Canadians and DLH entered into a joint venture, for which the Canadians provided financing of approximately \$2.6 million. These moneys represented the proceeds of the fraud perpetrated on El

¹ [1993] 3 All ER 717 (Millett J); rev'd, CA, [1994] 2 All ER 685. See also *Halifax Mortgages Ltd v Stepsky* [1995] 3 WLR 701.

² [1995] 2 AC 500.

³ [1993] AC 205.

⁴ [1994] 1 AC 428.

⁵ 13 February 1992 (unreported, Tuckey QC).

⁶ These cases, in particular *Kelly*, also have significant implications for Chinese walls.

⁷ See paras 2.3-2.4 above.

Ajou. Later, after Ferdman had ceased to be a director of DLH, the Canadians withdrew from the joint venture and DLH bought out their interest.

- 3.5 Both Millett J and the Court of Appeal held (i) that the proceeds of the fraud perpetrated by the Canadians could be traced into the funding of the joint venture and from there into the acquisition by DLH of the Canadians' interest; and (ii) that at the time Ferdman arranged for the moneys to be invested in the joint venture he must have known that they were part of the proceeds of fraud. The question of whether or not DLH could be held liable as constructive trustee for knowing receipt depended on whether the knowledge of Ferdman⁸ as to the tainted source of the funds could be attributed to DLH.⁹ Millett J and the Court of Appeal examined the two means by which that knowledge could have been acquired.
- 3.6 Millett J held, at first instance, that Ferdman's knowledge could not be attributed to DLH because of his status. In determining whether DLH had the requisite knowledge because of Ferdman's position as its chairman and as a director, he found as a fact that neither Ferdman, nor for that matter the board of DLH, played any significant role in determining its business policy or in making its business decisions. These responsibilities were performed by others who were not aware of the fraud.
- 3.7 Millett J also held that Ferdman's knowledge could not be attributed to DLH by means of normal agency principles. Although Ferdman was an officer of DLH, he had acquired knowledge of the Canadians' fraud as an officer of the Swiss company through which he carried on the business of Swiss fiduciary agent. Millett J held that where a person is a common officer of two companies, knowledge acquired as an officer of one will not be attributed to the other "unless he owes a duty to the first company to communicate his knowledge to the second company as well as a duty to the second company to receive it".¹⁰ On the facts of the case Ferdman could not have been under any duty to the Swiss company to communicate information about its clients or their associates to DLH without their authority.
- 3.8 On appeal his finding that Ferdman's knowledge could not be attributed to DLH because of his status as chairman and director was reversed. The Court of Appeal

⁸ Ferdman was the only member of the board who had this knowledge.

⁹ Both Millett J and the Court of Appeal held that the relevant transaction for the purposes of the "knowing receipt" claim was the acquisition by DLH of the Canadians' interest in the joint venture. However, the Court of Appeal differed from Millett J in holding that if DLH knew of the fraud at the time the joint venture was entered into, then this knowledge could carry over to the acquisition of the Canadians' interest. See para 3.14 below.

¹⁰ [1993] 3 All ER 717, 742, citing *inter alia* *Re Hampshire Land Co* [1896] 2 Ch 743; and *Re Fenwick Stobart & Co Ltd, Deep Sea Fishery Co's Claim* [1902] 1 Ch 507; on which see Consultation Paper No 124, para 2.3.9.

reasoned that Ferdman had the responsibility for arranging the receipt of the moneys, for which purpose he was the “directing mind and will”¹¹ of DLH, and the fact that with respect to other, more significant policy decisions he and the board were an irrelevance did not affect the matter. Thus when the joint venture was set up DLH knew that the moneys invested by the Canadians were the product of fraud.

3.9 Turning to the question of agency, the Court of Appeal agreed with Millett J that agency principles did not cause DLH to be affected by Ferdman’s knowledge. Nourse LJ endorsed Millett J’s analysis of the occasions when the knowledge of a common director could be attributed to the various companies of which he was a board member. Hoffmann LJ, with whom Rose LJ agreed, refined this analysis. He said that there were various categories of case where the agent’s knowledge will *ipso facto* be treated as that of the principal and which he considered were based on “distinct principles”.¹² He identified three such categories:¹³

- (i) cases where the agent is authorised to enter into a transaction in which his own knowledge is material, for example where a policy of insurance is avoided for failure by a broker to make disclosure of material facts within his knowledge, even though he did not obtain that knowledge in his capacity as agent of the insured;¹⁴
- (ii) cases where the principal has a duty to investigate or is put on inquiry. If the principal uses an agent then the knowledge of the agent will be imputed to the principal;¹⁵
- (iii) cases where the agent has actual or ostensible authority to receive communications on behalf of the principal, for example, a notice to quit.¹⁶

¹¹ *Lennard’s Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705, 713, *per* Viscount Haldane LC. For a discussion of the development of this point in the case of *Meridian*, see paras 3.15-3.23 below.

¹² [1994] 2 All ER 685, 702; he did not consider that they applied to the facts of *El Ajou*.

¹³ For a general discussion of the cases, see Bowstead, *The Law of Agency* (15th ed 1985) pp 412-420.

¹⁴ See *Blackburn Lowe & Co v Vigors* (1887) 12 App Cas 531. The other two examples cited by Hoffmann LJ were *Turton v London and North Western Railway Co* (1850) 15 LTOS 92; and *Dresser v Norwood* (1864) 17 CBNS 466.

¹⁵ It was in this category that he placed the so called “mad dog” cases, that is, where a dog owner is fixed with knowledge of the dog’s vicious propensities through the knowledge of his agent. Hoffmann LJ cited *Baldwin v Casella* (1872) LR 7 Ex 325. A respondent to the consultation paper also drew our attention to *Cleverton v Uffernel* (1887) 3 TLR 509; and *Colgett v Norrish* (1886) 2 TLR 471.

¹⁶ *Tanham v Nicholson* (1872) LR 5 561.

- 3.10 In other situations where an agent has a duty to communicate to his principal, Hoffmann LJ considered that the court could infer that the agent had in fact communicated the information, but that this was a rebuttable inference of fact.¹⁷
- 3.11 The *El Ajou* decision does not substantially affect the treatment of acquisition of knowledge by a company in the consultation paper. On the question of attribution because of the status of the person acquiring the knowledge it makes it clear that the *Lennard's Carrying Co Ltd* principle¹⁸ is context specific; whether or not a company will be held to have knowledge will depend on the particular transaction in respect of which the person who is allegedly its directing mind and will is acting.¹⁹ This was the view we had already expressed.²⁰
- 3.12 Similarly, the categorisation of the cases put forward by Hoffmann LJ does not affect the analysis in the consultation paper of the ways in which knowledge can be acquired by a principal under the rules of agency.²¹ What it does show, however, is that the analysis needs to be extended, in particular to a situation where a principal has a duty to enquire. What is unclear is whether or not the duty to enquire can arise from professional regulatory rules, for example, the suitability rule which implicitly requires a firm to obtain relevant information with respect to the customers to whom the obligation is owed.²² We can see no good reason why it should not be so extended and, if this is the case, then a firm would be aware of the information which the agent has acquired but which he has failed to pass on to the firm, since the duty to know is one imposed on the firm which the firm is discharging by using an agent.²³
- 3.13 Hoffmann LJ's reasoning would also be relevant in a situation where companies shared a common director and the director had an obligation to communicate information to one of the companies but failed to carry it out. In this situation, (subject to the "distinct categories" identified by Hoffmann LJ referred to above), the inference that he had so communicated it could be rebutted.

¹⁷ On the facts of *El Ajou* this inference had been rebutted since Millett J found that Ferdman had not communicated the information about the source of the moneys to DLH.

¹⁸ See para 3.8, n 11 above.

¹⁹ This point is explained and developed further in *Meridian*; see paras 3.15-3.23 below.

²⁰ Consultation Paper No 124, para 2.3.3.

²¹ See para 2.4 above. The legal context in which the rules of agency come into play was explained by Lord Hoffmann in the subsequent case of *Meridian*; see para 3.17 below.

²² The SIB Core Conduct of Business Rules, Rule 16(1): "other relevant facts about the customer of which the firm is, or reasonably should be, aware".

²³ For a possible limitation on this principle where the agent is not free to communicate the information, see *Halifax Mortgage Services Ltd v Stepsky* [1995] 3 WLR 701.

3.14 Millett J had held that even if Ferdman's knowledge had been attributable to DLH, the company should not be affected with this knowledge because either (i) it had not acquired the Canadians' interest in the joint venture until after Ferdman resigned from its board so that his knowledge could not be imputed to it for the purposes of that transaction, or (ii) where knowledge of a director is attributed to the company but not imparted to it, it should not be treated as continuing to possess that knowledge where the director has ceased to hold office or dies.²⁴ The Court of Appeal disapproved of this part of the judgment, not on the grounds that it was not possible for a company to forget, but on the more limited grounds that it considered the initial investment in the joint venture and the subsequent acquisition of the Canadians' interest to be effectively part of the same transaction.²⁵ Once knowledge was treated as being the knowledge of the company in relation to a given transaction, the company continued to be affected with that knowledge for any subsequent stages of the same transaction.²⁶ However, *El Ajou*, and in particular the judgment of Millett J in that case, supports the proposition that it might be possible for a company to forget.²⁷

Meridian

3.15 This case also concerns the acquisition of knowledge by a company. Koo and Ng were respectively Chief Investment Officer and senior portfolio manager of Meridian Global Funds Management Asia Ltd ("Meridian"), a substantial Hong Kong investment management company. They organised an unsuccessful fraudulent attempt to take over a New Zealand company ("ENC") and use the company's funds to finance the take over. Meridian became caught up in the fraud under which it acquired an interest in the shares of ENC. Under New Zealand legislation, Meridian was obliged to disclose its interest to ENC as soon as it knew or ought to have known that it was a "substantial security holder" in ENC's shares. Meridian was joined as a party to proceedings brought by the Securities Commission against the various participants in the fraud and, in the course of those proceedings, a declaration was made against Meridian that it had breached its duty of disclosure under the legislation.

3.16 The judge at first instance held that Meridian knew that it was a substantial security holder for the purposes of the relevant legislation by attributing to it the knowledge of Koo and Ng. Without too much discussion of the juridical basis he felt it was obvious that if Koo and Ng had authority to enter into the transaction, their knowledge that they had done so should be attributed to Meridian. The New Zealand Court of Appeal affirmed the decision on the somewhat different grounds

²⁴ [1993] 3 All ER 717, 742-743.

²⁵ See para 3.5, n 9 above.

²⁶ [1994] 2 All ER 685, 706, *per Hoffmann LJ*; 698, *per Nourse LJ*; 700, *per Rose LJ*.

²⁷ See Consultation Paper No 124, para 2.3.5. See para 2.5 above.

that Koo's knowledge should be attributed because he was the "directing mind and will" of the company.²⁸

3.17 In the Privy Council, Lord Hoffmann gave the opinion of the Board. He pointed out that there appeared to be some misunderstanding of the true principle upon which the *Lennard's Carrying Co Ltd* case (from which the expression "directing mind and will" was derived) was based. He said that the rules of attribution, which determine which acts count as acts of the company, were primarily to be found in the company's constitution, typically the articles of association, (which he referred to as the primary rules of attribution) but that these were supplemented by the principles of agency (which he referred to as the secondary rules of attribution). The company will appoint servants and agents whose acts, by a combination of the general principles of agency and the company's primary rules of attribution will count as acts of the company. Having done so, it will be subject to the general rules by which liability for the acts of others can be attributed to natural persons (notably estoppel, ostensible authority in contract and vicarious liability in tort).

3.18 This was usually sufficient to enable one to determine the company's rights and obligations. But there were situations where a rule of law, either expressly or by implication, excluded attribution on this basis (for example, if the rule required some act or state of mind on the part of the person "himself", as opposed to his servants or agents). Unless the court was to come to the conclusion that the rule was not intended to apply to companies at all, it had to fashion a special rule of (direct) attribution for the particular substantive rule. It was always a matter of interpretation of the substantive rule as to whether, and in what manner, it was intended to apply - whose act (or knowledge, or state of mind) was *for this purpose* intended to count as the act (or knowledge, or state of mind) of the company.

3.19 Against this background, Lord Hoffmann examined the *Lennard's Carrying Co Ltd* case. The provision in question was section 502 of the Merchant Shipping Act 1894 which provided a shipowner with a defence to a claim for the loss of cargo if he could show that the casualty happened "without his actual fault or privity". In considering how to apply this provision to a company, Viscount Haldane had, according to Lord Hoffmann, "looked for the person whose functions in the company, in relation to the cause of the casualty, were the same as those to be expected of the individual shipowner to whom the language primarily applied".²⁹ This person, who was responsible for monitoring the condition of the ship, authorising repairs etc, was described by Viscount Haldane as "the directing mind and will" of the company.

²⁸ *Lennard's Carrying Co Ltd v Asiatic Petroleum Ltd* [1915] AC 705, 713, per Viscount Haldane LC. See paras 3.8, 3.11 above.

²⁹ [1995] 2 AC 500, 509.

- 3.20 In the *Lennard's Carrying Co Ltd* case the company did nothing except own ships and so there was no need to distinguish between the person who ran the company's business in general and the person who was responsible for the condition of the ships. But in other cases it was more difficult to find an appropriate "directing mind and will" of the company. Lord Hoffmann said that the phrase would often be the most appropriate description of the person designated by the relevant attribution rule, but that not every case should be forced into the same formula.
- 3.21 Turning to the New Zealand securities legislation, Lord Hoffmann said that the purpose of the provision was to ensure immediate disclosure of the identity of persons who became substantial security holders in public companies. In the case of a corporate security holder, the knowledge of the person who, with the authority of the company, acquired the relevant interest should count as knowledge of the company for these purposes, otherwise the policy of the legislation would be defeated. The fact that Koo acquired the shares in ENC on behalf of Meridian for a corrupt purpose and did not give the required notice because he did not want his employers to find out had no effect on the attribution of knowledge and the consequent duty upon Meridian to notify. It was not necessary to inquire whether Koo could have been described in some more general sense as the "directing mind and will" of the company.
- 3.22 Lord Hoffmann stressed that it should not be understood that whenever a servant of a company had authority to do an act on its behalf, knowledge of that act would for all purposes be attributed to the company. It was a matter of construction in each case whether the rule required that such knowledge be attributed.
- 3.23 The *Meridian* decision develops further the consideration of the question of attribution because of the status of the person acquiring the knowledge. We have said³⁰ that *El Ajou* made it clear that the *Lennard's Carrying Co Ltd* principle was context specific - whether or not a company would be held to have knowledge would depend on the particular transaction in respect of which the person who is allegedly its directing mind and will is acting. *Meridian* takes this point further. It indicates that the phrase "directing mind and will" is simply one way of describing the person whose knowledge is to be regarded as that of the company for the purposes of the particular substantive rule. It is a matter of construction of the relevant rule (assuming the usual rules of agency cannot be applied) how it is to be translated to a corporate entity - whose knowledge (if anyone's), in the circumstances of the particular case, is to be relevant. Although the *Meridian* case develops and clarifies the law on this point, it remains in line with the approach set out in the consultation paper.³¹

³⁰ See para 3.11 above.

³¹ Consultation Paper No 124, para 2.3.3.

Kelly

- 3.24 This case concerns the scope of fiduciary duties and the impact of express and implied contractual terms on those duties. The plaintiff in this case was the vendor of a property and the defendants, a firm of estate agents, acted for him on the sale. The defendants also acted as agents for the vendor of the adjoining property. They showed a prospective purchaser, Mr Perot, around both properties. He made an offer for the adjacent property, which was accepted, and then made an offer for the plaintiff's property. The defendants passed on the offer to the plaintiff, but did not inform him that Mr Perot had agreed to buy the adjacent property. The plaintiff accepted the offer and both sales were completed. It was the plaintiff's case that a purchaser interested in acquiring adjoining properties might be prepared to pay over the ordinary price for the properties. Had he known that Mr Perot was interested in *both* properties he would have had the opportunity of seeking a higher price. The plaintiff brought an action for damages for breach of fiduciary duty on the grounds that the defendants (i) had failed to disclose the material fact that Mr Perot was also negotiating to buy the adjacent property, and (ii) had put themselves in a position where their duty to the plaintiff to disclose all relevant information pertaining to the sale conflicted with their personal interest in obtaining commission on both sales.
- 3.25 The Privy Council emphasised the contractual nature of the relationship between principal and agent and held that the rights and duties of a principal and agent are dependent upon the express and implied terms of the contract between them.³² It cited the dictum of Mason J of the High Court of Australia in *Hospital Products Ltd v United States Surgical Corporation*³³ in which he said that where a basic contractual relationship provided the foundation for the erection of a fiduciary relationship, the fiduciary relationship must accommodate itself to the terms of the contract so that it was consistent with and conformed to them. Lord Browne-Wilkinson, who delivered the opinion of the Board, concluded that "in the present case, the scope of the fiduciary duties owed by the defendants to the plaintiff (and in particular the alleged duty not to put themselves in a position where their duty and their interest conflicted) are to be defined by the terms of the contract of agency".³⁴

³² [1993] AC 205, 213-214. This contractual approach has been criticised; see Reynolds, "Agency" [1994] JBL 144, 149: "the rather brusque reasoning, and the citation of two cases on commercial distributors, seems to deny fiduciary obligations at all and to leave everything to express and even implied terms of the contract. Variable as the degree of fiduciary liability is, such reasoning cannot be appropriate to agency law in general. And it would be most unfortunate if it was taken as a *carte blanche* for persons acting in potentially inconsistent capacities in the area of financial services"; and Ian Brown, "Divided Loyalties in the Law of Agency" (1993) 109 LQR 206, 209: "Fiduciary duties are not dependent upon contractual undertakings nor, perhaps, should it be the dominant principle to 'define' these fundamental obligations by reference to the contract in question when the parties are at liberty to fix their rights and duties expressly. The Privy Council's hypothesis appears to let the tail of contract wag the dog of duty".

³³ (1984) 156 CLR 41, 97.

³⁴ [1993] AC 205, 215.

- 3.26 The contract between the plaintiff and the defendants in *Kelly* did not expressly set out or seek to limit the scope of the fiduciary duties owed by the defendants. When considering the rights and duties which arose in that case, Lord Browne-Wilkinson said that the business of estate agents inevitably gave rise to conflicts of interest between different principals, and that despite this “estate agents must be free to act for several competing principals otherwise they will be unable to perform their function”.³⁵ He emphasised that the customer of an estate agent would know that the agent would also act for vendors of comparable properties,³⁶ and concluded that in such cases it must be an implied term of the contract that the agent is entitled to act for other principals selling competing properties and to keep confidential the information it obtains from each.³⁷ He also said that it was not a breach of duty for the defendants to have a direct financial interest in securing commission on the sale of the adjacent property “since the contract of agency envisaged that they might have such a conflict of interest”.³⁸ The position as to confidentiality was said to be even clearer in relation to stockbrokers “who cannot be contractually bound to disclose to their private clients inside information disclosed to the brokers in confidence by a company for which they also act”.³⁹
- 3.27 However, the Privy Council in *Kelly* distinguished the case of *North and South Trust Co v Berkeley*⁴⁰ which held that as a general principle an agent must have express

³⁵ This seems to adopt the approach of implication of terms into contracts on the ground of necessity of giving business efficacy to the contract. For this approach see *The Moorcock* (1889) 14 PD 64, 68; *Liverpool City Council v Irvin* [1977] AC 239, 253: “although there is an apparently complete bargain, the courts are willing to add a term on the ground that without it the contract will not work”; *Chitty on Contracts - General Principles* (27th ed, 1994) Vol I, ch 13.

³⁶ [1993] AC 205, 214-215.

³⁷ This approach has been criticised; see Ian Brown, “Divided Loyalties in the Law of Agency” (1993) 109 LQR 206, 208-209 who argues that “[a]n agent owes a duty to communicate facts to his principal with due diligence and the defendant’s dilemma in *Kelly* should have been resolved by his seeking the consent of both principals to reveal Perot’s interest to the other. In the absence of dual consent it is suggested that the defendant should have terminated both agencies, or at least one of them”. He also suggests that both principals might have consented to divulge the facts to the other in the hope of legitimately gaining the ascendancy over Perot, and that the Privy Council’s analysis “enables the agent to classify information as confidential when it is by no means clear that it would be so characterised by his principals, thereby allowing the agent to consolidate his own position to the possible detriment of the principals’ best interests, *viz* in *Kelly*, the agent’s ensuring his commission on the sales of *both* houses”. See also *Mortgage Express Limited v Bowerman and partners* [1995] EGCS 129, described at para 3.39, n 71 below, and *Halifax Mortgage Services Ltd v Stepsky* [1995] 3 WLR 701.

³⁸ [1993] AC 205, 215.

³⁹ *Ibid*, at p 214.

⁴⁰ [1971] 1 WLR 470. This case concerned the practice of Lloyd’s insurance brokers of acting as agent for both the customer and the underwriter in settling a claim.

consent before acting for two parties in the *same* transaction.⁴¹ The two principals in *Kelly* were involved in different transactions, and the general principle that a firm must not act for two customers in the same transaction unless it has obtained their informed consent, is still valid.

- 3.28 We consider the impact of *Kelly* on our provisional conclusions by looking at four aspects: first, the use of express contractual terms to define the extent of the fiduciary duties; secondly, the extent to which terms may be implied into contracts which limit the fiduciary duties; thirdly, the use of Chinese walls; and lastly, the incorporation of terms by trade custom.

Express contractual terms

- 3.29 This decision confirms our provisional view that the court will have regard to all the terms of the contract or instrument when determining whether a relationship is fiduciary and, if so, the scope of the fiduciary's duties.⁴² Subject to the proviso that the court will have regard to substance and not form,⁴³ the decision makes it clear that where a fiduciary relationship arises out of a contract, a clearly worded duty defining or exclusion clause will circumscribe the extent of the fiduciary duties owed to the other party.⁴⁴ It also indicates that an unambiguous general advanced disclosure made in a contract will be effective, provided that the contract clearly delimits the rights and duties of the parties to it and displaces the obligation to make full disclosure of all material facts. We are, therefore, no longer of our provisional view that a general advanced contractual disclosure is unlikely to be widely effective.

Implied terms

- 3.30 Where appropriate provision has *not* expressly been made in the contract and where the customer's informed consent has not been obtained to the firm so acting, *Kelly* is authority for the proposition that a firm may be permitted (i) to act for customers with conflicting interests in different transactions and to keep confidential the information obtained from each;⁴⁵ and (ii) in some circumstances to put itself in a position where its duty to a customer conflicts with its own self-interest. To this extent, we have revised our provisional view that in order for a firm to avoid

⁴¹ *North and South Trust Co v Berkeley* [1971] 1 WLR 470, 482. See Consultation Paper No 124, para 3.2.17.

⁴² See para 2.11 above.

⁴³ See para 2.12 above and paras 3.41-3.42 below. A clause may also be subject to the UCTA reasonableness test and the requirement of fairness in the Unfair Terms in Consumer Contracts Directive; see paras 2.12 above and 4.2-4.8 below.

⁴⁴ This assumes that the firm manages its relationships with its customers so as to avoid the introduction of new rights and obligations into it over time. Most respondents did not regard this as a problem. See para 7.3 below.

⁴⁵ See para 3.32 below for a possible limitation on this.

breaching its fiduciary duties to its customers by acting in a situation of conflict it is necessary⁴⁶ for it expressly to make a sufficiently clear and precise provision in the contract with the customer, or obtain the customer's informed consent to its so acting.⁴⁷

3.31 However, there are three situations of conflict in which, despite *Kelly*, it will be necessary either to make appropriate provision in the contract or obtain the informed consent of the customer in order to avoid breaching a fiduciary duty. The first is where the firm is acting for two customers in the same transaction.⁴⁸ The second is where there is a conflict between the firm's own interest and the duty which it owes to a customer and that conflict is more acute than that which arose in *Kelly*. The conflict of interest in *Kelly* arose from the agent's financial interest in securing a second commission on the sale of the adjoining property in a situation where the plaintiff "was well aware" that the defendants would be acting for vendors of comparable properties. The conflict would be more acute if, for example, (i) a firm has a direct beneficial interest in a transaction with a customer, such as where it sells its own property to a customer,⁴⁹ or (ii) the discretionary fund management arm of a firm purchases the commercial paper issued by a company for a client at a time when the corporate finance department is calling in a loan to that company which will cause it to default on the commercial paper. The third situation is where there has been "iniquity".⁵⁰ This might arise when a sectoral analyst who has been made an insider by the corporate finance department in relation to a particular stock returns to his normal duties before the inside information he has obtained is in the public domain or has ceased to be price sensitive. If, on the basis of his last published opinion, the analyst advised a customer to purchase the stock, despite having inside knowledge that the stock was about to fall in price, although the court would not hold that the analyst should have committed a criminal offence and disclosed the inside information to the customer,⁵¹ it might well consider that the

⁴⁶ There are two exceptions to this; see para 2.13, n 33 above.

⁴⁷ Although, where possible, it is preferable to make express provision to avoid any doubt.

⁴⁸ See *Harrods Ltd v Lemon* [1931] 2 KB 157, discussed at paras 12.6-12.7 below. In a simple agency cross where the transactions of two customers are matched and the customers are protected by the requirement of best execution, the rules on trade custom will probably provide a solution; see para 7.6 below.

⁴⁹ This would have been the case in *Kelly*, for example, if the adjoining property had been beneficially owned by the estate agents.

⁵⁰ In *El Ajou* [1994] All ER 685, 703, Hoffmann LJ rejected a submission that on the basis of *Kelly* no term could be implied into a contract requiring an agent to disclose that money was the proceeds of fraud. This was because a "confidence in iniquity" would not be enforced.

⁵¹ See para 3.35 below.

firm should not have placed itself in a position of conflict which would require it deliberately to mislead a customer.⁵²

3.32 Beyond these three situations the extent to which terms may be implied into contracts which limit the fiduciary duties owed to the other party will depend on whether *Kelly* is given a wide or a narrow interpretation. The agent in *Kelly* offered a single service, the provision of estate agency services. When illustrating the principle by relation to stockbrokers, Lord Browne-Wilkinson referred only to customers of the broker.⁵³ The Privy Council did not consider the duties which would (or would not) be owed to the customer of one department of a multifunctional financial conglomerate in relation to the functions carried out by other departments of the conglomerate. In principle, we believe that the reasoning in *Kelly* is equally applicable to the situation where a conflict arises between the interests of two or more customers of different departments of a financial conglomerate for whom it is acting in different transactions. However, in *Kelly* Lord Browne-Wilkinson emphasised that the plaintiff would be “well aware” that the defendants would be acting for the vendors of competing properties, and that the exclusion of the relevant fiduciary duties was necessary if estate agents were to be able to perform their function. While it will be clear to any customer of a broker that the broker acts for other customers, and that the broker would not be able to operate without doing so, the large range of different functions which the different departments of a financial conglomerate carries out for customers may be less obvious to any one customer of a particular department, especially if the customer is an inexperienced private customer.⁵⁴ If a court were to adopt a narrow view of *Kelly* it might hold that there was a duty on the firm not to put itself in a position of conflict without making full disclosure to the customer,⁵⁵ in a situation where a customer was not aware that a firm would be acting for other customers in different transactions with competing interests.

Chinese walls

3.33 *Kelly* did not involve a Chinese wall and the Privy Council did not consider Chinese walls. It does not therefore give express judicial recognition to their effectiveness,

⁵² See para 8.6, n 4 below.

⁵³ [1993] AC 205, 214.

⁵⁴ See A Alcock, “*Kelly v Cooper* - a timely decision” (1994) 14(7) *Company Lawyer* 134, 136: “Customers of estate agents use them because of their other customers. However, private client investors do not generally pick a stockbroking firm because of its corporate finance connections Indeed, since Big Bang, most private client investment businesses have been separated from the big corporate finance brokers, so that a private client investor will not necessarily expect his broker to be conducting a conflicting corporate finance business. Any limitation of the undivided loyalty rule extending beyond the rival interests of investing customers may not meet the ... ‘officious bystander’ test without prior notification, at least to private clients”.

⁵⁵ In such circumstances the court would, however, be likely to hold that there was no duty to use the information for the benefit of the customer.

but it does have significant implications for them, in particular in relation to the fiduciary's duty of disclosure and his duty not to put himself in a position of conflict. We consider these two aspects both where there is express provision in the contract for a Chinese wall and where there is not.

- 3.34 Since *Kelly* has confirmed that the scope of fiduciary duties can be defined by the terms of the contract of agency,⁵⁶ it is now clear that the duty of disclosure to a customer will be limited where it is an express term of the contract between firm and customer either (i) that the firm utilises Chinese walls to restrict the flow of information and that the customer is not entitled to any information which the actual member of the firm with whom he deals does not (and would not reasonably be expected to) have in his possession,⁵⁷ or (ii) that the firm is not obliged to disclose to the customer any information the disclosure of which would or might be a breach of duty to any other person, or which properly does not come to the attention of the person dealing with the customer.⁵⁸ However, where Chinese walls are used to manage conflicts, such express terms may be insufficient on their own to avoid liability for breach of a firm's duty not to put itself in a position where its own interests conflict with those of the customer, or where it owes conflicting duties to another customer, since they neither disclose expressly the fact that such conflicts may exist, nor seek to vary those duties.⁵⁹
- 3.35 Where a contract does not acknowledge and provide for the use of Chinese walls the position is less clear. The Privy Council in *Kelly* recognised that a firm could not be obliged to use confidential information gained from one customer for the purposes of another and said that brokers could not be contractually bound to disclose inside information disclosed to them in confidence by a company for which they also act.⁶⁰ In the light of this statement, Chinese walls could be seen simply as devices designed to ensure that something that could not be contractually done was in

⁵⁶ See paras 3.25, 3.29 above.

⁵⁷ An example of such a term given to us by one consultee was: "You recognise and accept that practices and procedures, including those commonly known as Chinese walls, are maintained in parts of our Group and of individual Group companies to restrict the flow of information. You agree that, when we are acting for or dealing with you, any information of which none of our individual executives having the conduct of the matter has actual or properly obtainable knowledge shall not for any purpose be taken into account in determining our responsibilities to you. It is agreed between us that evidence of any such Chinese wall is not conclusive evidence of its effectiveness".

⁵⁸ See, for example, Institutional Fund Managers' Association/British Merchant Banking and Securities Houses Association *Terms and Conditions for Discretionary Fund Management* (Ed IFMA/BMBA2) September 1991, clause 31.

⁵⁹ Arguably, it is implicit in the nature of Chinese walls, which are widely used in practice, that conflicts between the firm's interests and those of its customers, or between the interests of different customers, may arise so that term (i), which discloses that a Chinese wall may be used, is effective in these situations. However, it is clearly preferable for the contract to spell out expressly that the duties are varied so as to permit such conflicts.

⁶⁰ See para 3.26 above.

actual fact not done. However, as explained above,⁶¹ *Kelly* is not authority for the proposition that a firm can, without more, put itself in a position where its own interest conflicts with a duty owed to a customer, or where it owes conflicting duties to two customers for whom it is acting in the same transaction. Thus in the situation where either (i) a firm's own interest on one side of a Chinese wall conflicts with the interests of a customer for whom another department of the firm on the other side of the wall is acting,⁶² or (ii) different departments of a firm on the opposite sides of a Chinese wall act for different customers in the same transaction, the firm, while not being obliged to use inside information for the customers, might, nevertheless, breach the duty not to put itself in a position of conflict. Moreover, although we believe that the approach taken in *Kelly* will usually mean that a firm will not be in breach of fiduciary duty where it acts for two customers with competing interests in *different* transactions, much will depend on whether on any future occasion the court takes a wide or narrow view of *Kelly* in the circumstances of the particular case.⁶³

Trade custom

- 3.36 In *Kelly* the Privy Council did not consider the rules relating to the incorporation of terms into contracts by trade custom. However, as we explain in Part VII of this report, we believe that the approach taken in *Kelly*⁶⁴ may have an influence on the way the rules on incorporation by custom are interpreted in the future. We have therefore departed from our provisional conclusion on this matter.⁶⁵ We now consider that an English court would take the same approach as the New South Wales Court of Appeal in *Jones v Canavan*⁶⁶ and hold that a trade custom which permits a fiduciary to act in a position of conflict is reasonable if the custom also provides adequate protection for the customer's interests.

Clark Boyce

- 3.37 This case also concerns the role of contract in determining the scope of fiduciary duties. It involved the loan of a sum of money to a businessman on the security of the house of his mother, the plaintiff. The defendant solicitors acted for both the plaintiff and her son in the mortgage transaction. Before acting for the plaintiff, the defendants repeatedly advised her to seek independent legal advice and advised her

⁶¹ See para 3.31 above.

⁶² An example of such a situation is example (ii) in para 3.31 above.

⁶³ See para 3.32 above.

⁶⁴ In *Kelly* the court was prepared to take a pragmatic approach and look at the commercial context in which the transaction took place. This approach was echoed in *Target Holdings Ltd v Redfern* [1995] 3 WLR 352. See para 3.40, n 72 below.

⁶⁵ See paras 2.8-2.10 above.

⁶⁶ [1972] 2 NSWLR 236. See para 2.9 above and Consultation Paper No 124, paras 3.2.20-3.2.22.

of the consequences of non-payment of the loan by her son. The son went bankrupt and the plaintiff became liable to repay the loan and arrears of interest. The plaintiff sued the defendants alleging, *inter alia*, that they had breached their fiduciary obligations by failing (i) to refuse to act for her; (ii) to advise her that it was not in her interests to enter the transaction; and (iii) to advise her adequately of the need for independent legal advice.

3.38 The Privy Council held that there was no general rule of law that a solicitor should never act for both parties in a transaction where their interests might conflict. A solicitor could so act if he had obtained the informed consent of both parties to his so doing. Informed consent was said to mean “consent given in the knowledge that there is a conflict between the parties and that as a result the solicitor may be disabled from disclosing to each party the full knowledge which he possesses as to the transaction or may be disabled from giving advice to one party which conflicts with the interests of the other”.⁶⁷ To this extent the decision confirms what we said in the consultation paper to the effect that fiduciary duties can be modified or displaced if the consent of the person to whom a duty is owed is obtained after full disclosure of all material facts has been made.⁶⁸

3.39 However, the Privy Council went on to emphasise the importance of establishing precisely what services are required of the fiduciary when a court has to determine whether or not informed consent has been obtained.⁶⁹ It indicated that the scope of a solicitor’s duties to a client is limited by his instructions and said that a fiduciary duty “cannot be prayed in aid to enlarge the scope of the contractual duties”. As there was no contractual duty on the defendants to advise the plaintiff on the wisdom of entering into the transaction,⁷⁰ there could be no fiduciary duty to give that advice. Nor was there a duty to refuse to act for the plaintiff since she was fully

⁶⁷ [1994] 1 AC 428, 435.

⁶⁸ See paras 2.13-2.15 above.

⁶⁹ [1994] 1 AC 428, 436.

⁷⁰ *Ibid*, at p 437. All that was required of the defendants in the circumstances of the case was that they should carry out the necessary conveyancing on the plaintiff’s behalf and explain to her the legal implications of the transaction; *ibid*, at p 437.

aware of what she was doing and had declined to seek independent advice, although advised to do so.⁷¹

- 3.40 The importance given in *Clark Boyce* to the role of the contract when determining the extent of the fiduciary duty relating to disclosure of material facts underlines the approach taken by the Privy Council in *Kelly*. It is another indication that, where the relationship between fiduciary and beneficiary arises out of a contract, the courts will have regard to the terms of the contract in determining the scope of fiduciary duties.⁷²

Glynwill

- 3.41 This case also considered the extent to which the contract can determine the scope of fiduciary duties. The defendant firm was a foreign exchange dealer. It acted for the plaintiff in currency transactions, charging a commission and also, in some cases, taking a mark-up on the price at which it had bought in the market.⁷³ It did not disclose the mark-up to the plaintiff. The plaintiff contended that the defendant was acting as its agent and was therefore liable to account for the mark-up. The defendant claimed that it was acting, as the contract between it and the plaintiff specified, as principal. However, the deputy judge concluded that in the light of the other evidence, including the agreement of commission and the market order method used by the plaintiffs,⁷⁴ the trading relationship was one of principal and

⁷¹ In *Mortgage Express Ltd v Bowerman and partners* [1995] EGCS 129, it was held by the Court of Appeal that there was a duty on a solicitor, who was acting for both a lender and borrower in a conveyancing transaction, to inform both of his clients of information which cast doubt on the valuation obtained. It was common ground that, had the information been confidential to the borrower, the solicitor should have sought instructions to disclose the information to the lender and, if such consent was refused, he should have declined to act. There would have been a conflict between the duty of confidentiality and the duty to protect the lender's interest. However, this was not the case and no question of conflict arose. The solicitor was simply negligent in failing to inform the lender of the information which was relevant to the valuation of the property. See also *Halifax Mortgage Services Ltd v Stepsky* [1995] 3 WLR 701.

⁷² Both cases demonstrate the courts' willingness to examine the commercial context of transactions involving fiduciary duties. This approach was echoed by the House of Lords in *Target Holdings Ltd v Redfern* [1995] 3 WLR 352 where a solicitor wrongly paid away moneys received as part of a conveyancing transaction. In examining the transaction Lord Browne-Wilkinson distinguished between the equitable principles applicable to traditional trusts and those applying to bare trusts arising in commercial transactions. In this case the money was held on a bare trust and the solicitor's obligation to restore the funds was extinguished once the underlying commercial transaction had been completed. There was no reason for the specialist rules which had developed in relation to traditional trusts to be applied in this commercial context. Lord Browne-Wilkinson emphasised that the depositing of the money with the solicitor was just one aspect of the arrangements between the parties, which were for the most part contractual.

⁷³ For the current regulatory position on this practice, see SFA Board Notice 143, 6th August 1993.

⁷⁴ "On a market order, that is to say, to buy at market rate without limit of price (which I find was the method most frequently used by the plaintiffs ...) [the defendant] could mark up the price which they obtained from the market maker without telling the client they had done so. The client would be stuck with the price at which their order was filled

agent. The plaintiff was therefore entitled to recover the amount of the mark-up from the defendant.

- 3.42 This case demonstrates that the categorisation of a relationship in a contract is not conclusive. It illustrates the point made in the consultation paper that in determining whether a relationship is fiduciary the court will look at the substance of a relationship in the light of its commercial context and the entirety of the obligations undertaken by the firm, and not just at the label which is given to the relationship in the contract.⁷⁵ We believe that this principle survives *Kelly*, and that although the terms of the contract are of primary importance in delimiting the scope of fiduciary duties, the court will not give effect to a “mere sham”⁷⁶ which contrives to evade the real nature of the relationship.

without having had an opportunity to accept or reject it. So there would be a sale by [the defendant] to the client at a price which it had never been able to consider in circumstances where the seller has taken no risk, knows the buyer's position and is also making a commission on the transaction Such uncertainty, where the market may be changing every second, illustrates how untenable [the defendant's] position is.”

⁷⁵ See para 2.12 above and Consultation Paper No 124, para 3.3.12(iii).

⁷⁶ *Ex p Delhasse* (1877) 7 Ch 511, 526, *per* James LJ; 532, *per* Baggallay LJ. See Consultation Paper No 124, para 3.3.12(iii).

PART IV LEGAL DEVELOPMENTS - DIRECTIVES, STATUTES AND REGULATIONS

Introduction

- 4.1 In this part we consider legislative developments and examine the Directive on Unfair Terms in Consumer Contracts;¹ the Investment Services Directive;² and Part V of the Criminal Justice Act 1993.

Directive on Unfair Terms in Consumer Contracts

- 4.2 The UTCCD was implemented in the UK, under section 2(2) of the European Communities Act 1972, as the Unfair Terms in Consumer Contracts Regulations 1994.³ These regulations came into force on 1 July 1995 and were accompanied by Guidance Notes issued by the DTI in July 1995.⁴ The directive subjects terms in standard form consumer contracts to a requirement of fairness and therefore has a potential impact on the effectiveness of duty defining/exclusion clauses in modifying rights against fiduciaries so as to avoid a mismatch between fiduciary duties and requirements imposed by regulatory rules. To a certain extent the UTCCD overlaps with the Unfair Contract Terms Act 1977 which was considered in detail in the consultation paper,⁵ but it is in some respects wider and in other respects narrower in its application. The DTI has considered the relationship between UCTA and the UTCCD⁶ and despite the suggestions of many consultees to its original consultation document⁷ that it should align the two, by equating the test of reasonableness in UCTA with the test of fairness in the directive, it has come to the conclusion that it is not possible to do so. While recognising that in most cases the application of these tests will achieve the same result, the DTI considers "that it would be inconsistent with the proper implementation of the directive to treat the concept of

¹ Council Directive 93/13/EEC (OJ L95, 21.4.93, p 29).

² Council Directive 93/22/EEC (OJ L141, 11.6.93, p 27).

³ SI 1994 No 3159. See generally, G H Treitel, *The Law of Contract* (9th ed 1995) pp 245-259; Hugh Beale, "Legislative Control of Fairness: The Directive on Unfair Terms in Consumer Contracts" in *Good Faith and Fault in Contract Law* (J Beatson, D Friedmann ed 1995) p 231.

⁴ Department of Trade and Industry, *The Unfair Terms in Consumer Contracts Regulations 1994 (SI 1994 No 3159) Guidance Notes* (July 1995).

⁵ See para 2.12 above and Consultation Paper No 124, paras 3.3.24-3.3.38.

⁶ Department of Trade and Industry, *Implementation of the EC Directive on Unfair Terms in Consumer Contracts (93/13/EEC), A Further Consultation Document* (September 1994).

⁷ Department of Trade and Industry, *Implementation of the EC Directive on Unfair Terms in Consumer Contracts (93/13/EEC), A Consultation Document* (October 1993).

fairness as equivalent to the existing test of reasonableness in the Act".⁸ As a result the UTCCD creates a separate regime alongside UCTA.

4.3 Unlike UCTA, the UTCCD applies only in favour of natural persons acting for purposes outside their trade, business or profession (referred to as "consumers")⁹ and to contract terms which have not been "individually negotiated".¹⁰ However, it is not limited to "exclusion clauses" and so any distinction between duty defining and exclusion clauses is irrelevant.¹¹ On the other hand, terms which define the main subject matter of the contract, or concern the adequacy of the price or remuneration against the goods or services sold or supplied (the so called "core provisions") are excluded from the test of fairness, in so far as these are in plain, intelligible language.¹² In the financial services field the UTCCD will cover contracts for the sale and purchase of securities and for the provision of advice and other services (such as portfolio management).¹³ The DTI takes the view that it does not apply to the *creation* and *issue* of financial securities as the issuer is neither selling goods nor supplying a service.¹⁴

4.4 The directive does not apply to terms which "reflect mandatory statutory or regulatory provisions".¹⁵ This phrase is slightly confusing. The word "mandatory" suggests requirements which *must* be followed or satisfied. The French text refers to "dispositions ... *imperatives*" which in general means provisions which cannot be contracted out of by the parties. However, recital 13 specifically states that this

⁸ Department of Trade and Industry, *Implementation of the EC Directive on Unfair Terms in Consumer Contracts (93/13/EEC)*, A Further Consultation Document (September 1994).

⁹ Art 2; regs 2(1), 3.

¹⁰ Art 3; reg 3.

¹¹ For a discussion on this point in relation to UCTA, see Consultation Paper No 124, paras 3.3.28, 3.3.31.

¹² Art 4(2); reg 3(2).

¹³ Unlike UCTA, the UTCCD also applies to insurance contracts although not to terms which define and circumscribe the insured risk and the insurer's liability, see recital 19. Under the regulations, these restrictions are treated simply as examples of the "core provisions". See paras 3.26-3.27 of the Guidance Notes.

¹⁴ A number of recitals make specific reference to the sale of goods and supply of services (recitals 2, 5, 6 and 7) and the DTI has indicated that it regards the Directive as applying *only* to such contracts (see Department of Trade and Industry, *Implementation of the EC Directive on Unfair Terms in Consumer Contracts (93/13/EEC)*, A Consultation Document (October 1993) and paras 3.4-3.12 of the Guidance Notes). This is reflected in the definitions of "seller" and "supplier" in the regulations (reg 2(1)) which differ in this respect from the definition of "seller or supplier" in the directive (Art 2(c)). For an opposing view, see Hugh Collins, "Good Faith in European Contract Law" (1994) 14(2) OJLS 229, 242. On the specific question of shares and bonds, see paras 3.23-3.25 of the Guidance Notes. On the question of scope, see also Richard Thomas, "Unfair Terms in Consumer Contracts Regulations - The Impact in the Financial Services Industry" (May 1995) BJB & FL 214, 217.

¹⁵ Art 1(2).

wording “also covers rules which, according to the law, shall apply between the contracting parties *provided that no other arrangements have been established*”. It therefore envisages that the phrase does cover provisions which the parties can vary by agreement. In the light of this ambiguity the DTI has omitted the word “mandatory” from the implementing regulations.¹⁶ The question remains, however, as to what terms can be said to “reflect statutory or regulatory provisions”.

4.5 It seems that the exclusion was aimed at avoiding cases of “double jeopardy” where a contract which satisfies accepted criteria under national or international law is then susceptible to attack as unfair under the new directive.¹⁷ The full text of the exclusion refers also to terms which reflect “the provisions or principles of international conventions to which the Member States or the Community are party” and a particular concern of a number of Member States was that terms which were accepted in international conventions on transport should not be subject to further scrutiny under the directive.¹⁸

4.6 Looking at the regulatory structure under the FSA, it seems clear that in so far as the rules of the SIB and (probably) the SROs and RPBs¹⁹ impose obligatory requirements on firms carrying on regulated business, terms in the contracts between the firms and their customers which incorporate those requirements cannot be challenged as unfair under the UTCCD. At the other extreme, it cannot be said that just because a firm operates in a regulated environment and complies with the regulatory rules by which it is bound its contractual terms are above challenge. There must, at the very least, be a direct correlation between the term and a particular regulatory rule. Subject to this point, the exclusion contained in the directive is capable of applying broadly, but much will depend on the interpretation given by the courts and ultimately by the European Court of Justice.²⁰

¹⁶ SI 1994 No 3159, Sched 1. They have also slightly amended the wording of the provision in the regulations so that it refers to any term “*incorporated in order to comply with or which reflects ...*”.

¹⁷ See para 3.15 of the Guidance Notes.

¹⁸ See Department of Trade and Industry, *Implementation of the EC Directive on Unfair Terms in Consumer Contracts (93/13/EEC)*, A Consultation Document (October 1993).

¹⁹ We consider that the rules of the SROs and RPBs would probably be considered as “regulatory provisions” for these purposes even though they have no statutory rulemaking powers since they operate within a statutory framework set up under the FSA and, in order to obtain recognition, must comply with the requirements of scheds 2 and 3 respectively of the Act which include provisions in respect of their rules. The same may also be said of Recognised Investment Exchanges and Clearing Houses, see FSA, ss 36-39.

²⁰ One particular area of doubt may be the extent to which terms which reflect practices which are “permitted” rather than “required” by the self-regulatory bodies could be subject to challenge under the directive. See Richard Thomas, “Unfair Terms in Consumer Contracts Regulations - The Impact on the Financial Services Industry” (May 1995) BJB & FL 214.

4.7 The UTCCD requires member states to ensure that terms which are “unfair” shall not be binding on the consumer.²¹ A term is to be regarded as unfair if (i) it is “contrary to the requirement of good faith” and (ii) it “causes a significant imbalance in the parties’ rights and obligations arising under the contract to the detriment of the consumer”.²² Good faith is not defined in the Directive but the recitals provide guidance as to the factors which are relevant in its assessment.²³ These are reflected in schedule 2 of the implementing regulations which provides that regard shall be had to the following matters:

- the strength of the bargaining positions of the parties;
- whether the consumer had an inducement to agree to the term;
- whether the goods or services were sold or supplied to the special order of the consumer;
- the extent to which the seller or supplier has dealt fairly and equitably with the consumer.

4.8 It is difficult to assess how the unfairness test will be applied to duty defining and exclusion clauses. Many clauses may be considered to cause a “significant imbalance” in the parties’ rights to the detriment of the consumer. But to be unfair they must also be contrary to the requirement of good faith. The factors to be taken into account in assessing good faith are similar to those contained in schedule 2 of UCTA for determining the “reasonableness” of a term for the purposes of certain sections under the Act. It seems, therefore, that the concept of good faith may well include elements of reasonableness.²⁴ In the circumstances it seems unlikely that English courts will find that a term passes the UCTA reasonableness test but fails the UTCCD fairness test. However, there may be cases where terms would be contrary to the requirements of good faith and yet are deemed reasonable and *vice versa*.²⁵ Further, the courts will be bound to follow any decisions of the European Court of Justice on the meaning of “good faith” which could lead to a divergence between the two concepts.

²¹ Art 6; reg 5.

²² Art 3(1); reg 4. Art 3(3) sets out an “indicative and non-exhaustive list of terms which may be regarded as unfair”; see also sched 3 of the implementing regulations.

²³ Recital 16.

²⁴ The European Parliament recommended the introduction of a test of reasonableness in an amendment to the original proposed Directive (Opinion of 20.11.91, Minutes 42 11 (PE 157.273), Amendment No 10) but the Commission did not take up this suggestion when redrafting the Directive. According to Meryll Dean, “Unfair Contract Terms: The European Approach” (1993) 56 MLR 581, at the Council meeting on 29 June 1992, when the common position text was agreed it was made clear that reasonableness should form part of the test of unfairness in Art 3(1).

²⁵ Department of Trade and Industry, *Implementation of the EC Directive on Unfair Terms in Consumer Contracts (93/13/EEC), A Further Consultation Document* (September 1994).

Investment Services Directive

- 4.9 The ISD enables a firm authorised to provide investment services in one member state to provide investment services in any other member state without requiring local authorisation. The ISD places responsibility for authorisation and prudential supervision on the “home state”²⁶ and gives responsibility for conduct of business rules to the “host state”.²⁷ Home member states must draw up prudential rules which require investment firms, *inter alia*, to “be structured and organised in such a way as to minimise the risk of clients’ interests being prejudiced by conflicts of interest between the firm and its clients or between one of its clients and another”.²⁸ The rules of conduct to be drawn up by host member states must, as a minimum, implement certain principles set out in the directive. These include the requirement that an investment firm “tries to avoid conflicts of interests and, when they cannot be avoided, ensures that its clients are fairly treated”.²⁹
- 4.10 The ISD is due to be implemented by measures coming into force no later than 31 December 1995. The Treasury and the SIB have published consultation documents on its implementation which do not propose widespread changes to the existing structure.³⁰ Very broadly, the FSA will be amended by regulations to allow firms authorised to conduct ISD investment business in other member states to carry on that business in the UK without seeking authorisation here, subject to a notification procedure. These “passport” firms will either become members of the relevant SRO for their business (in which case they will have to abide by the conduct of business rules of the SRO) or they will be regulated direct by the SIB. Section 48 of the FSA will be amended so as to apply to passported firms broadly in the same way as it does to UK authorised persons, including the power for the SIB to designate rules to apply to them under section 63A.³¹ No significant changes are proposed to the substance of the rules and principles themselves, although a clearer distinction between “prudential” rules which are the responsibility of the home state and “conduct of business” rules which are the responsibility of the host state is envisaged.

²⁶ The state where the investment firm’s registered office or, if it has no registered office, the state where its head office is situated, Art 1(6).

²⁷ The state in which the investment firm has a branch or provides services, Art 1(7).

²⁸ Art 10.

²⁹ Art 11(1).

³⁰ HM Treasury, *Implementation of the Investment Services Directive and the Capital Adequacy Directive, A Consultation Document issued by HM Treasury* (July 1994); SIB, *Implementation of the Investment Services Directive and Capital Adequacy Directive, Discussion Paper* (July 1994). The SROs have also issued consultation documents; see for example SFA, *The Investment Services Directive, Board Notice 194* (14 July 1994); IMRO, *Implementation of The Investment Services Directive, Consultation Document 23* (June 1995); PIA, *Implementation of the Investment Services Directive and Capital Adequacy Directive, Information Document* (May 1995).

³¹ See Consultation Paper No 124, paras 2.5.6-2.5.9. See also para 5.3 below.

4.11 In the consultation paper we considered very briefly a draft of the directive and noted that any Chinese wall arrangement that was recognised by the implementing legislation would be squarely part of public law which could override the common law.³² In fact, the implementing legislation will not deal with Chinese walls directly, but it will allow the SIB to apply its existing conduct of business rules, including those made under section 48(2)(h) which deal with Chinese walls,³³ to passported firms in the same way as UK firms.³⁴ We do not consider, therefore, that the ISD itself has any effect on the extent to which Chinese wall arrangements may be regarded as having public law authority so as to modify inconsistent common law and equitable duties.³⁵ However, the directive is relevant in considering how any reform which we propose is to apply to passported firms.³⁶

Criminal Justice Act 1993

4.12 The Company Securities (Insider Dealing) Act 1985 has been repealed by the Criminal Justice Act 1993³⁷ and replaced by Part V of the latter Act.³⁸ Part V is intended to implement the Insider Dealing Directive.³⁹ Although Part V differs in a number of respects from the 1985 Act, these differences have no significance for any of the issues addressed in this report. Insider dealing remains a criminal offence.⁴⁰ Therefore what was stated in the consultation paper with respect to the 1985 Act, that the law would not compel a fiduciary to disclose information where such disclosure would constitute a criminal offence,⁴¹ applies with equal force to Part V.

³² Consultation Paper No 124, para 4.6.2. See further on the public law aspects of Chinese walls paras 7.19-7.30 below.

³³ See para 5.4 below. See also Consultation Paper No 124, paras 5.3.16-5.3.22.

³⁴ What constitutes "conduct of business" rules for the purposes of the ISD may not be exactly the same as what are at present referred to as conduct of business rules by the various regulatory bodies. If particular regulatory requirements are in fact "prudential" rules for the purposes of the ISD they may not be applied to the passported firms. The ISD does not refer specifically to Chinese walls although both Art 10 (conduct of business rules) and Art 11 (prudential rules) refer to conflicts of interest (see para 4.9 above). We consider that rules on Chinese walls made under FSA, s 48(2)(h) do qualify as conduct of business rules for these purposes.

³⁵ Our views on this point are set out at paras 7.19-7.30 below.

³⁶ See para 16.17, n 41, n 42 below.

³⁷ Criminal Justice Act 1993, Sched 6.

³⁸ Part V came into effect on 1 March 1994. See also Money Laundering Regulations SI 1993 No 1933; Insider Dealing (Securities and Regulated Markets) Order SI 1994 No 187; Traded Securities (Disclosure) Regulations SI 1994 No 188.

³⁹ Council Directive 89/592/EEC (OJ L334, 18.11.89, p 30).

⁴⁰ Criminal Justice Act 1993, s 52(3). The penalties are set out in s 61. As with the 1985 Act, breach of Part V does not render any contract void or unenforceable; s 63(2). This does not mean that the contract, if executory, would be enforceable; see *Chase Manhattan Securities Ltd v Goodman* [1991] BCLC 897.

⁴¹ Consultation Paper No 124, paras 4.5.16-4.5.17, 4.5.25.

PART V REGULATORY DEVELOPMENTS

Introduction

- 5.1 In this part we examine recent regulatory developments. We consider the Large Report,¹ which made recommendations about the future of financial services regulation; the recognition of a new self-regulating organisation, the PIA, which was set up to regulate the investment business primarily done with or for the private customer; and the recent changes to the rules on disclosure of commission.²

The Large Report

- 5.2 In July 1992, in the wake of the Maxwell affair, the Chancellor of the Exchequer asked Andrew Large, the chairman of the SIB, to undertake a review of the way the SIB carries out its responsibilities under the FSA with particular reference to the way it exercises oversight of the recognised bodies for which it is responsible.³ The Large Report sets out his findings and conclusions. The main recommendations of the report have now been substantially implemented,⁴ but further changes to the regulatory structure are under consideration.⁵
- 5.3 For the purposes of the present project the most important point arising from the Large Report was the recommendation that the SIB should act more as a standard setter and less as a formal legislator, and that the recognised bodies should be given greater freedom to develop their own rules.⁶ Large recommended that the SIB's power to designate rules should be used more sparingly in the future and that, in due course, existing core conduct of business rules should be de-designated.⁷ This recommendation has now been implemented and, with the exception of Rule 36 and Rule 40(4)(a) and (b) (so far as relevant to Rule 36), the Core Rules are no longer designated.⁸ This means that any recommendation for reform which was dependent upon the previous structure of designation of Core Rules would conflict with the new approach and be impractical.⁹

¹ Large, *Financial Services Regulation - Making the Two Tier System Work* (May 1993).

² The Financial Services (Conduct of Business) (Product and Commission Disclosure) Rules 1994.

³ The full terms of reference are set out on page 1 of the Large Report.

⁴ See SIB, *Annual Report 1994/1995* p 11.

⁵ See "SIB to press for rewrite of City rules" *Financial Times* 19 July 1995.

⁶ Large Report, chapter 6.

⁷ Large Report, paras 6.10-6.11.

⁸ The Financial Services (Dedesignation) Rules and Regulations 1994.

⁹ It also means that any reform would have to be sufficiently flexible to cope with changes to the rulebooks of the self-regulating organisations and with any additional changes to the regulatory regime which may prove necessary in the future.

- 5.4 Core Rule 36 deals with Chinese walls. In its consultation document prior to dedesignation¹⁰ the SIB indicated that, because doubts had been expressed in the past about the efficacy of Chinese walls at common law, it seemed “appropriate that firms should continue to enjoy the *statutory* comfort which can be conferred by a designated SIB rule”.¹¹ We have already summarised our conclusions in the consultation paper on the effectiveness of Chinese walls as a matter of private law and given our views on the impact of recent legal developments on those conclusions.¹² We discuss in Part VII below how far Chinese walls arrangements can be said to have statutory recognition as a result of the designated Core Rule 36.¹³

The Personal Investment Authority

- 5.5 A further example of changes to the regulatory regime is the setting up of the PIA which was recognised by the SIB as a self-regulating organisation with effect from 18 July 1994. The PIA’s role is to regulate investment business which is primarily done with or for the private customer. Its members have been drawn largely from those firms which were previously members of FIMBRA and LAUTRO¹⁴ (which are being disbanded).¹⁵ The PIA’s initial “transitional framework” of rules relies on and incorporates substantial parts of the existing rules of FIMBRA and LAUTRO, but it is introducing its own rules in stages, following extensive consultation with member firms.¹⁶

Rules on disclosure of commission

- 5.6 In the consultation paper we explained that for an agent to take a commission, full disclosure must be made to the customer. We expressed the view that, unless validated by custom or within the “usual practice rule”,¹⁷ disclosure of only the basis of commission is unlikely to satisfy common law requirements. In the field of life insurance the rules on disclosure of commission have been tightened up considerably, following concern initially expressed by the Office of Fair Trading that it was necessary to increase disclosure requirements to ensure market

¹⁰ SIB, *Dedesignation of The Core Conduct of Business Rules, The Client Money Regulations and The Financial Supervision Rules*, Consultative Paper 83 (August 1994).

¹¹ *Ibid*, para 11.

¹² See paras 2.16, 3.33-3.35 above. For further discussion on this point, see paras 7.12-7.18 below.

¹³ See paras 7.19-7.30 below.

¹⁴ See Consultation Paper No 124, para 2.5.11.

¹⁵ The SIB revoked the recognitions of FIMBRA and LAUTRO as SROs in June 1994. Revocation was made subject to a transitional wind-down period which has been extended to 1 October 1996.

¹⁶ The PIA’s primary concern has been to produce rules in relation to the ISD and Capital Adequacy Directive, but it hopes to cover all areas in the course of 1996.

¹⁷ See para 2.13, n 33 above.

competitiveness.¹⁸ New rules have been issued by the SIB,¹⁹ the most significant parts of which came into effect on 1 January 1995. It is now necessary for sellers of life insurance to provide, amongst other things, full details of all commission to be received (including non-cash benefits such as the use of a company car) in writing before the contract is concluded.²⁰ We consider that the new rules will satisfy the common law requirements of full advanced disclosure of commission in the area which they cover.

5.7 In the area of non life products, such as unit and investment trusts, the PIA has also proposed²¹ major changes to the content and form of information to be given to customers. The new rules which have been put forward would involve a regime similar to that for life insurance. It is envisaged that these will be operative by the second half of 1996.

¹⁸ Office of Fair Trading, *The Marketing and Sale of Investment-Linked Insurance Products* (March 1993); Office of Fair Trading, *Fair Trading and Life Insurance Savings Products* (March 1993).

¹⁹ The Financial Services (Conduct of Business)(Product and Commission Disclosure) Rules 1994.

²⁰ *Ibid*, Part 5.

²¹ PIA, *Consultative Paper No 8, Product and Commission Disclosure* (1995); PIA, *Consultative Paper No 2, Product and Commission Disclosure* (1994).

SECTION C THE ISSUES ARISING FROM CONSULTATION

PART VI SUMMARY OF PROVISIONAL CONCLUSIONS AND CONSULTATION ISSUES

Introduction

- 6.1 In this section we examine the responses received to the consultation issues and consider their impact on our provisional conclusions. We deal with each of the questions raised in the consultation paper in turn in Parts VII-XII. Before doing so, we summarise our primary provisional conclusions on the issues on which consultees were invited to comment.¹

Provisional conclusions and consultation issues

- 6.2 First, we said that as a general rule, neither exclusion clauses nor disclosure and consent were a foolproof means of modifying the normal incidents of a particular fiduciary relationship so as to avoid any mismatch between fiduciary duties and the duties imposed by regulatory rules.² Second, we said that it was unclear whether, as a matter of private law, the existence of an effective Chinese wall would provide protection to a fiduciary in a conflict situation.³ Finally, we concluded that although this might already be the law, the uncertainties about the current position should be resolved by a statutory rule that the court should take account of reasonable regulatory rules in ascertaining the precise content of relevant fiduciary obligations.⁴
- 6.3 We also considered four further legislative possibilities in the consultation paper: first, the codification of fiduciary duties;⁵ secondly, the legitimisation of generalised advanced consents;⁶ thirdly, a change to the rules of attribution within a corporation or partnership so that the present irrebuttable presumption of knowledge between

¹ Our provisional conclusions on a number of the matters, and the reasons for them, have already been summarised at paras 2.3-2.16 above in considering the impact of recent legal and regulatory developments.

² Consultation Paper No 124, para 7.9.

³ *Ibid*, para 7.13. We did suggest, however, that there may be a public law solution in so far as rules made under FSA, s 48(2)(h) may modify common law and equitable duties; see Consultation Paper No 124, para 7.20. See also paras 7.19-7.30 below.

⁴ Consultation Paper No 124, paras 7.22-7.23.

⁵ *Ibid*, para 7.25(i).

⁶ *Ibid*, para 7.25(ii).

different parts of an organisation would be replaced by a rebuttable presumption;⁷ and finally, that legislation could provide for the exculpation of fiduciaries who, although they have breached their fiduciary duties, are considered by the court to have acted honestly and reasonably.⁸ We provisionally concluded that the first of these was both impractical and undesirable and that the second was unattractive as it might not make an adequate distinction between acceptable and unacceptable practices. We did not form any provisional view on the remaining two possibilities. We will now consider respondents' views on these matters and on the specific issues on which comment was invited.

⁷ Ibid, para 7.25(iii).

⁸ Ibid, para 7.25(iv).

PART VII MODIFICATION OF THE NORMAL INCIDENTS OF A FIDUCIARY RELATIONSHIP BY EXCLUSION CLAUSES, DISCLOSURE AND CONSENT, AND CHINESE WALLS (Question 1)

Consultation issue

- 7.1 The first matter on which we invited comment was set out in the following terms in the consultation paper:¹

Can conflicts between fiduciary duties and what is permitted by the regulatory rules be completely avoided by the use of all or some, and if so which, of the following methods of modifying the normal incidents of a particular fiduciary relationship:

- (a) exclusion clauses,
- (b) disclosure and consent, and
- (c) Chinese walls?

Our provisional view is that, under private law, they cannot.

Summary of respondents' views

- 7.2 Respondents to the consultation paper were divided in their views on this issue. Most of the financial services practitioners said that these methods were completely effective, while most of their legal advisers and most of the academic lawyers who replied thought that they had limitations. Overall, at the initial stages of consultation, there was uncertainty as to the extent to which these methods were capable of modifying particular aspects of fiduciary duties. However, after the decision of the Privy Council in *Kelly*,² a number of respondents, including the SIB and several legal practitioners, indicated that they now considered that contractual techniques, and in particular duty defining clauses, should be effective in most circumstances. Few comments were received from those operating in sectors other than the financial services industry, but comments from accountancy and surveyors' interests indicated that problems of mismatch between fiduciary duties and regulatory rules rarely occurred, because the regulatory rules governing those activities tended to require full disclosure and consent in conflict situations. There

¹ Consultation Paper No 124, pp 240-241.

² See paras 3.24-3.36 above.

follows an analysis of the breakdown of opinion on the separate points raised in the question.

Exclusion clauses

- 7.3 At the stage of written submissions, most of the respondents who addressed this issue thought that exclusion clauses, and more particularly duty defining clauses, circumscribed the extent of fiduciary duties, although a small number thought that they would not always do so. Few gave any reasons in support of their view. However, after the decision in *Kelly* there was virtual unanimity among those who made further submissions to us that exclusion and duty defining clauses were an effective means of varying the incidents of a fiduciary relationship. Although some respondents acknowledged that these techniques might not always prevent the introduction of new duties into a relationship as it evolved, this was not regarded as a major problem. One respondent suggested that if a firm did not manage its relationships with its clients in such a way as to avoid the introduction of new duties over time, it did so at its own risk. We examined *Kelly* in detail in paragraphs 3.24-3.36 above, and concluded that it is now clear that the scope of the fiduciary duties owed by an agent to his principal is defined by the express and implied terms of the contract of agency, and that a clear and unambiguous³ duty defining or exclusion clause will delimit the scope of the fiduciary duties owed to the customer.⁴ However, in determining whether a relationship is fiduciary, and if so the extent of the fiduciary duties, its description in the contract will not be conclusive if it does not reflect the true substance of the relationship.⁵

Disclosure and consent

- 7.4 Two thirds of the respondents who commented on disclosure and consent, thought that in the consultation paper we had taken too narrow a view of the circumstances in which general advanced disclosures would be effective. The main reason they gave was that, where general advanced disclosure was sanctioned by regulatory rules, this situation would give rise to a trade custom permitting a reduced level of disclosure. Another reason given by one respondent was that the courts might be prepared to adapt to modern day realities and accept that conflicts of interest are inevitable in multifunctional financial conglomerates, and to take a more flexible position on general advanced disclosure in some (unspecified) circumstances, although he acknowledged that there was no clear authority to support this proposition.

³ Exclusion clauses are strictly construed against the person who seeks to rely on them, ie contra proferentem; see para 2.12 above.

⁴ See paras 3.25, 3.29 above. Exclusion and duty defining clauses will also be subject to the controls imposed by UCTA and the Directive on Unfair Terms in Consumer Contracts, where applicable; see paras 2.12, 4.2-4.8 above.

⁵ See paras 2.12, 3.41-3.42 above.

7.5 As to the first reason given, where a general advanced disclosure is made in a contract it is not necessary to turn to the rules on trade custom to establish whether it is effective to limit the extent of the fiduciary's duties. This is because it is now clear that the scope of an agent's fiduciary duties can be defined by the terms of his contract with his principal.⁶ However, it is necessary to consider whether the rules on incorporation of a contractual term by trade custom make other forms of disclosure (or non-disclosure) effective where permitted by regulatory rules. The rules on incorporation of terms into contracts by trade custom were summarised in paragraph 2.8 above. We said in the consultation paper⁷ that, as a general rule, there would be little difficulty in proving that the rules of regulatory bodies satisfied the factual requirements for trade customs. However, once it had been established that a regulatory rule fulfilled the requirements of a trade custom, we said that it would only be incorporated into the contract if it was reasonable. It was our provisional view that a custom which modified a firm's fiduciary duty would usually be held to be unreasonable, and that it would not, therefore, bind the customer in the absence of his fully informed consent. However, we noted the possibility that a trade custom which permitted a fiduciary to act in a position of conflict might be held to be reasonable if it did so only where the trade custom protected the customer's interests, for example, by fixing a fair price at which orders were to be matched.⁸

7.6 Although a number of respondents disagreed with our conclusions on the law relating to trade customs, none cited any authority in support of their view, other than those we had already discussed in the consultation paper.⁹ In *Kelly and Clark Boyce* the Privy Council did not consider the rules on incorporation of terms into contracts by trade custom.¹⁰ However, we believe that these cases indicate that the courts will adopt a less restrictive approach to the interpretation of fiduciary duties than we thought likely at the time of the consultation paper. An important feature of *Kelly* for the purposes of this discussion is that the Privy Council implied a term that the estate agent did not have to divulge relevant confidential information and that this implication arose from the structure of the industry.¹¹ We, therefore, believe that in future cases the court will follow *Jones v Canavan*¹² and hold a trade

⁶ *Kelly v Cooper* [1993] AC 205 and *Clark Boyce v Mouat* [1994] 1 AC 428. See paras 3.24-3.40 above.

⁷ Consultation Paper No 124, para 3.2.12.

⁸ *North and South Trust Co v Berkeley* [1971] 1 WLR 470; *Jones v Canavan* [1972] 2 NSWLR 236. See paras 2.8-2.10 above.

⁹ Consultation Paper No 124, section 3.2.

¹⁰ See para 3.36 above.

¹¹ On the position in relation to stockbrokers, see n 14 below.

¹² [1972] 2 NSWLR 236. See paras 2.8-2.10 above and Consultation Paper No 124, paras 3.2.20-3.2.21.

custom which permits a fiduciary to act in a situation of conflict to be reasonable if it incorporates adequate protection for the customer's interests. If so, in situations where a regulatory rule permits a lower level of disclosure than that required of a fiduciary by common law and equity, the court might be willing to hold that it is an implied term of the contract that the customer is entitled only to the level of disclosure permitted by the relevant rule, provided that it incorporates adequate protection for the customer. For example, SFA Conduct of Business Rule 5-33(3) permits a broker who simultaneously matches the transactions undertaken by two customers, taking a commission from each, not to disclose to either customer the nature or amount of the commission received from the other.¹³ The courts might now¹⁴ hold that it is a trade custom that the firm is able to match transactions without disclosing the double commission it has received, and that this custom is incorporated into the contract with the customer because the customer's interests are adequately protected by SFA Conduct of Business Rule 5-39 which provides that the firm must provide best execution.¹⁵

7.7 Another example is the disclosure of soft commission arrangements in accordance with IMRO Rule 1.7.¹⁶ This rule provides that before a firm enters into a customer agreement authorising it to effect transactions for the customer under a soft commission agreement, it must inform the customer in writing of the existence of the soft commission agreement and the firm's policy relating to soft commission agreements.¹⁷ It must also send an annual report to the customer giving details of several matters. These must include the percentage of total commission paid by the firm under soft commission agreements, the value of goods and services ("softing services") received by the firm expressed as a percentage of the total commission paid by the firm, a summary of the softing services received by the firm, a list of counterparties to soft commission agreements, and the total commission paid from

¹³ See SFA Conduct of Business Rule 5-34 and Consultation Paper No 124, para 3.4.23 on disclosure where the firm is required to send a contract note to the customer.

¹⁴ In *Kelly* the Privy Council said that it was clear that stockbrokers could not be contractually bound to disclose to one customer information obtained from another, and indicated that such an agent must be entitled to act for other customers selling competing shares. But it was not made clear whether the court would imply a limit on the fiduciary duty of undivided loyalty where a broker matches the transactions of two customers. Although the decision in *Kelly* does not extend to the situation where an agent acts for two parties in the same transaction (see paras 3.27 and 3.31 above), we believe that since matching transactions is a simple case in which the customer is adequately protected by the requirement of best execution, the courts would probably adopt the more flexible approach to implication by custom outlined in the text above.

¹⁵ See Consultation Paper No 124, paras 3.4.21-3.4.25 on disclosure of double commission.

¹⁶ See also SFA Conduct of Business Rule 5-8.

¹⁷ IMRO Rule 1.7(3).

the portfolio of that customer.¹⁸ We explained in the consultation paper¹⁹ that, although this disclosure would probably protect the firm from liability for placing itself in a position where its duty to the customer conflicted with its own interest, it might not protect the firm from liability for making a secret profit (by retaining the element of the softing services which is attributable to the customer's transaction without making full disclosure of this element and obtaining the customer's consent to its retention). However, if a court were to adopt the wider approach to implication by trade custom, we believe that it would hold that the level of disclosure required by the rules would be sufficient and that there was no secret profit. This is because the rules on soft commission are designed to ensure that customers' interests are safeguarded. They specify that the only benefits which may be provided under a soft commission agreement are those which can reasonably be expected to assist in the provision of investment services to customers, and which are so used; that the broker must agree to provide best execution; that the firm must be satisfied that the terms of business and methods by which the relevant broking services will be supplied do not involve any potential for comparative price disadvantage to the customer; and that in transactions in which the broker acts as principal the firm is satisfied that commission paid under the agreement will be sufficient to cover the value of the softing services to be received and the costs of execution.²⁰

- 7.8 This argument that a trade custom which is underpinned by regulatory rules and which incorporates adequate protection for the customer permits a reduced level of disclosure would not assist in cases where the regulatory rule is regarded merely as setting the minimum standard of disclosure, and it is common practice to make further disclosure. In those cases it would be difficult to show that there was a sufficiently uniform and certain course of conduct to amount to a trade custom. Nor will the argument necessarily provide a solution in cases where the regulatory rules do not address the question of disclosure. If the rules permit a practice which conflicts with fiduciary requirements, but do not address the question whether that practice should be disclosed to the customer, the need to obtain the informed consent of the customer to the practice will only be obviated as a matter of custom if the practice itself satisfies the requirements of a trade custom. For example, Core Rule 36 on Chinese walls does not specify whether or not it is necessary to disclose that a Chinese wall is in place, and it appears to assume that it is not necessary to obtain the consent of the customer where information has not passed across the wall.²¹ The variety in the type and monitoring arrangements of Chinese walls which

¹⁸ IMRO Rule 1.7(4).

¹⁹ Consultation Paper No 124, paras 3.4.26-3.4.28.

²⁰ IMRO rule 1.7(1).

²¹ See Consultation Paper No 124, para 4.5.13. The full text of Core Rule 36 appears at Appendix C.

can satisfy the rule make it unlikely that a sufficiently certain and uniform practice can be established in relation to Chinese walls to enable the use of any particular Chinese wall to constitute a trade custom.²²

7.9 The position where the regulatory rules do not address the practice in question at all is even clearer. One example is the rule relating to the disclosure of commission to a non-private customer.²³ In such circumstances it cannot be argued that a regulatory rule authorising a lower level of disclosure has been incorporated into the contract. Although it may be anomalous for a lower level of disclosure to be permitted in relation to a private than a non-private customer, if the rules do not address the issue there is no conflict between common law and equitable requirements and the provisions of the regulatory rules, and the matter is outside the remit of this project.

7.10 We indicated above²⁴ that one respondent considered that we had taken too narrow a view of the circumstances in which general advanced disclosure would be effective because the courts would adapt to modern day realities. In the light of the Privy Council decisions in *Clark Boyce* and *Kelly*, we agree that the courts are adopting a less restrictive approach to questions about fiduciary duties where a fiduciary relationship has a contractual basis.²⁵ We now believe that a sufficiently precise general advanced disclosure made in a contract will be effective provided that the contract clearly delimits the fiduciary duties owed to the customer and displaces the obligation to make full disclosure of all material facts, and the customer has not been misled as to the nature of the relationship between the parties.²⁶ We also believe that when issues about informed consent arise, the court will look at precisely what services were required of the fiduciary when assessing whether there has been adequate disclosure of material facts and it will not require disclosure of matters which fall outside the scope of the contractual duties.²⁷

Chinese walls

7.11 This part of the question raised two issues: first, whether Chinese walls modify fiduciary duties as a matter of private law; and second, whether, as a matter of public law, section 48(2)(h) of the FSA authorises the SIB to make a rule (Core

²² Although, as we explain in paras 7.19-7.30 below, Chinese walls may be susceptible to another solution; they may be effective as a matter of public law. See paras 2.16, 3.33-3.35 above and 7.11-7.30 below on Chinese walls generally.

²³ SFA Conduct of Business Rule 5-33(2), which permits limited disclosure of commission, applies only to private customers. See Consultation Paper No 124, paras 3.4.19, 5.3.13-5.3.15 on SIB Core Rule 18(2).

²⁴ Para 7.4.

²⁵ See paras 3.24-3.40 above. See also *Target Holdings*, para 3.40, n 72 above.

²⁶ See paras 3.25, 3.29, 3.40 above.

²⁷ See paras 3.39-3.40 above.

Rule 36) modifying both the duty of disclosure which arises under the undivided loyalty rule²⁸ and the present law on attribution of knowledge within a single entity.

As a matter of private law

- 7.12 On the first issue, a number of respondents disagreed with our provisional conclusion that as a matter of private law, the Chinese wall did not afford the type of protection that is needed for a firm to carry on its functions with the degree of assurance that the wall is designed to provide.²⁹ They considered that Chinese walls could prevent the attribution of knowledge. The main reasons³⁰ they gave were that too much emphasis had been placed on the law firm disqualification cases,³¹ that the decision in *Kelly* opened the way for the legal recognition of Chinese walls, and that the consultation paper's analysis of the law on attribution of knowledge was faulty.
- 7.13 It is helpful to distinguish three different stages in considering whether Chinese walls can offer sufficient protection to firms as a matter of private law. The first concerns the process of acquisition of knowledge by the firm; the second addresses the issue of whether knowledge, once acquired by a firm, is treated as being in the possession of all parts of the firm; the third considers how far it is possible to escape the consequences of knowledge. The law firm disqualification cases and *Kelly* are relevant to the third stage. The criticisms on attribution relate to the second stage. The first stage is important since if there is no acquisition of knowledge by the firm in the first place there can be no conflict of duty in respect of that knowledge.
- 7.14 We considered the law on the acquisition of knowledge in paragraphs 2.3-2.6 and 3.2-3.23 above.³² We concluded that knowledge would be acquired by a company where either (i) the status of the person within the firm who has acquired the knowledge ("the agent") with respect to the relevant transaction results in his knowledge being that of the firm;³³ or (ii) where knowledge is attributed under

²⁸ See para 1.4 above.

²⁹ See para 2.16 above.

³⁰ A number of respondents also referred to the case of *Bowater v Norton Opax*. This was an interlocutory, unreported decision of Brooke J in chambers (5 September 1989), in which he refused to grant an injunction on the application of a party to a takeover struggle, which objected to a firm, whose services it had previously used, now acting for the party with which it was in conflict, even though effective Chinese walls were in place in that firm.

³¹ *Re a Solicitor* (1987) 131 SJ 1063; *Lee (David) & Co (Lincoln) Ltd v Coward Chance* [1991] Ch 259; *Re a Firm of Solicitors* [1992] 1 All ER 353. See further Consultation Paper No 124, paras 4.5.7-4.5.11. See *Re a Firm of Solicitors* [1995] 3 All ER 482, for a recent discussion of these cases.

³² See also paras 12.4-12.13 below.

³³ As indicated above, *Meridian* has confirmed that it is a question of construction in each case whether the knowledge of the agent will be attributed directly to the company for the purposes of the particular transaction in question; see para 3.23 above.

normal rules of agency because, adopting the categories of Hoffmann LJ in *El Ajou*,³⁴ either the knowledge of the agent is directly material to the transaction, or the firm has a duty to enquire, or the agent has actual or ostensible authority to receive communications on behalf of the firm. If any of these conditions are satisfied the knowledge will be treated as being the knowledge of the firm even if it was not communicated to it by the agent.

7.15 In the consultation paper we said that where the firm is a company, then as a matter of principle any matter known by one part of the firm would be known by all parts of the firm.³⁵ A Chinese wall will not prevent the attribution of knowledge between the component parts of the firm.³⁶ The criticisms of our analysis on this point are addressed at paragraphs 12.5-12.7 below. For the reasons given there, we still consider that the statement is correct, since it flows from what we regard as a principle that there cannot be “partial ignorance”, and since no one has cited any case which recognises such a state.

7.16 The key question, therefore, is the extent to which the firm can escape the consequences of knowledge. With regard to the impact of the law firm disqualification cases, we explained in the consultation paper³⁷ that the reasoning in these cases could not automatically be transferred to relationships other than those between lawyer and client, because it was influenced by special considerations which are unique to the lawyer-client relationship. Our doubts about the effectiveness of Chinese walls, on their own,³⁸ as a means of preventing breach of fiduciary duty were not based primarily on those cases, but on the “undivided loyalty” and “no conflict” principles of fiduciary law which, in the absence of anything in a contract to the contrary, mean that the fiduciary must not place itself in a position where its own interest conflicts with that of a customer or where its duty to one customer conflicts with the duty owed to another, and that it must make available to a customer all the information in its possession that is relevant to that customer’s affairs.³⁹

7.17 As explained in paragraphs 3.34-3.35 above, in the light of the decision in *Kelly* we have reconsidered our provisional conclusion on the effectiveness of Chinese walls

³⁴ See para 3.8 above.

³⁵ Consultation Paper No 124, paras 2.3.6-2.3.7. See also para 2.5 above.

³⁶ Although it might do so as between different companies which form part of a group. See paras 2.5 above and 12.10 below.

³⁷ Consultation Paper No 124, para 4.5.11.

³⁸ As we stated in the consultation paper, if the informed consent of the customer is obtained to the use of the Chinese wall to staunch information flows within the firm, the Chinese wall will provide protection; Consultation Paper No 124, para 4.5.16 and para 2.16 above.

³⁹ See para 1.4 above and Consultation Paper No 124, paras 2.4.9, 4.5.17-4.5.18, 4.5.25.

on their own⁴⁰ as a means of preventing breach of fiduciary duty. We indicated that *Kelly* does not legitimise Chinese walls in themselves as a means of managing conflicts of interest and of duty. However, we believe that the approach taken in *Kelly* will generally mean that a Chinese wall will protect a firm where different departments on either side of the wall are acting for different customers in different transactions.⁴¹ But, where either (i) a firm's own interest on one side of a Chinese wall conflicts with the interests of a customer for whom another department of the firm on the other side of the wall is acting, or (ii) different departments of a firm on the opposite sides of a Chinese wall act for different customers in the same transaction the firm, while not being obliged to use confidential or inside information for the customers, might breach the duty not to put itself in a position of conflict.⁴²

- 7.18 Reasons have already been given why the variety in the type and monitoring arrangements of Chinese walls which can satisfy Core Rule 36 means that they are unlikely to satisfy the requirements of a trade custom.⁴³ We, therefore, remain of the view expressed in the consultation paper that unless appropriate provision is made in an express contractual term, Chinese walls cannot, as a matter of private law, always be relied upon as a means of modifying a firm's duty not to put itself in a position where its duty towards one customer conflicts with the duty that it owes to another customer, or with its own interest.

As a matter of public law

- 7.19 In relation to the second issue, our provisional view was that, although the matter was not without doubt, FSA, section 48(2)(h) probably authorised rules which modified the common law and equitable duties owed to the customer to disclose or make use of relevant information where a Chinese wall was used.⁴⁴ This view was based on the wording of section 48(2)(h) which authorises the making of rules:

enabling or requiring information obtained by an authorised person in the course of carrying on one part of his business to be withheld by him from persons with whom he deals in the course of carrying on another part and for that purpose enabling or requiring persons employed in one part of that business to withhold information from those employed in another part.

⁴⁰ Ie in the absence of a contractual provision permitting their use; see para 3.35 above.

⁴¹ Although it was pointed out that much will depend on whether the court takes a wide or narrow view of *Kelly*; para 3.32 above.

⁴² See para 3.31 above.

⁴³ See para 7.8 above.

⁴⁴ Consultation Paper No 124, paras 5.3.20-5.3.21, 5.4.1. On the question of acting in a position of conflict, see para 7.21 below.

7.20 We said that as a firm could not be “enabled” to withhold information if it was in any event free to do so, it could be argued that the subsection must be concerned with the situation where there was a common law or equitable duty of disclosure. If that was correct we said that unless the section empowered the modification of such duty, a firm would not be “enabled”. We also pointed out that if the section did not empower the modification of the common law or equitable duty of disclosure, a regulatory requirement to “withhold” information would subject a firm to conflicting regulatory and fiduciary duties. The reason for this was that withholding information, as “required” by the regulatory rules, would necessarily constitute a breach of the common law or equitable duty to disclose the information, while disclosure to satisfy the general law would necessarily breach the regulatory “requirement”.⁴⁵ We indicated that this interpretation of the subsection was supported by an additional factor, the fact that by FSA, section 48(6), compliance with rules made under section 48(2)(h) is a defence to a criminal charge under section 47.⁴⁶ We said that to that extent it was clear that the rules had an effect beyond the regulatory scheme. We suggested, moreover, that it would be odd if that which was required to avoid criminal and regulatory liability automatically involved exposure to another kind of liability (for breach of common law or equitable duties).⁴⁷

7.21 In considering the effect of rules made under section 48(2)(h) in the consultation paper, our discussion centred on the obligation to disclose or to use information. It is of course equally important from a firm’s point of view that it should not be regarded as having breached its obligations simply by the fact of continuing to act in a situation where it owes conflicting duties to two customers on either side of a Chinese wall, or where its own interests on one side of the wall conflict with those of a customer on the other side. This distinction between using information and acting in a conflict situation was highlighted earlier in considering the impact of *Kelly* on Chinese walls.⁴⁸ In so far as section 48(2)(h) and Core Rule 36 authorise a firm to withhold information in certain situations, we consider that they also authorise the firm to act despite the conflicts which necessarily arise in those situations. In other words, although section 48(2)(h) and Core Rule 36 only refer to the withholding of information, by implication they also have the effect of enabling a firm to act in a position of conflict.

7.22 Most of the respondents who commented on our provisional view, agreed with it. However, three respondents disagreed with that view. Two suggested that Core Rule 36 was ultra vires. One of those, Mr A G J Berg, put forward two reasons for this

⁴⁵ Consultation Paper No 124, para 5.3.20.

⁴⁶ See para 7.23 below. The full text of FSA, ss 47 and 48(6) appears at Appendix B.

⁴⁷ Consultation Paper No 124, para 5.3.21.

⁴⁸ See paras 3.33-3.35 above.

point of view. First, he said that rules made under section 48, including those made under paragraph (h) of subsection (2), must “regulate the conduct of investment business”.⁴⁹ To do so they must impose “obligations or restrictions” on the activities of authorised persons.⁵⁰ Core Rule 36 does not impose sufficient obligations or restrictions since it leaves it to each individual firm to decide what information it will disclose to or withhold from the people with whom it deals and the circumstances in which such information will be disclosed or withheld. It cannot therefore, according to Mr Berg, be construed as *regulating* investment business.⁵¹ However, the case on which Mr Berg relies is clearly directed at the interpretation of the particular statutes under consideration, namely the Agricultural Marketing Acts. These Acts contained sections which set out various mandatory and optional provisions which were to be included in schemes set up under the Acts. The court took all those provisions into account in deciding whether the scheme being challenged was of the type envisaged by the Acts. The scheme was in fact primarily directed at advertising and publicity, and not at regulation in the sense envisaged by the statutes. In our view, it is the rules as a whole which must be looked at in considering whether they are authorised under section 48, and not just one particular rule. There is no doubt that the rules made under section 48 do “regulate investment business” on any reasonable interpretation, and Core Rule 36 is just one part of that body of rules.

7.23 Secondly, Mr Berg said that rules made under paragraph (h) of subsection (2) in effect exempt firms from criminal liability under section 47,⁵² and that it cannot have been intended that they should create an exemption without imposing real requirements and constraints, strict compliance with which would be necessary if the benefit of the exception was to be obtained. He suggested that this view is supported by the wording of section 48(6) which refers to matters done “in

⁴⁹ According to Mr Berg FSA, s 48(2) is merely an “in particular” list of certain matters for which provision may be made by rules “regulating the conduct of investment business” under subsection (1).

⁵⁰ *Tuker v Ministry of Agriculture, Fisheries and Food* [1960] 2 All ER 834, where the Court of Appeal held that a purely discretionary scheme could not properly be described as one “*regulating* the marketing of an agricultural product” for the purposes of the Agricultural Marketing Acts 1931 to 1949.

⁵¹ For a discussion on the expression “regulating investment business” in the context of construing whether FSA, s 48(2)(h) authorises rules modifying common law duties, see para 7.29 below.

⁵² FSA, s 47 creates certain offences relating to misleading statements and practices and includes an offence of making a statement which a person (including a firm) knows to be misleading for the purposes of inducing another person to enter into an investment agreement. By virtue of FSA, s 48(6) it is a defence to liability under FSA, s 47 if the firm has acted in conformity with rules made under FSA, s 48(2)(h) (ie Core Rule 36). In other words, the firm would not be treated as “knowing” information for these purposes if the department dealing with the other person was unaware of it as a result of a Chinese wall complying with Core Rule 36. The full text of FSA, ss 47, 48(2)(h) and 48(6) appears at Appendix B and the full text of Core Rule 36 appears at Appendix C.

conformity” with rules made under paragraph (h) of subsection (2). Core Rule 36, he said, effects a “general and unconditional” disapplication of the offences under section 47 which section 48(2)(h) does not empower the SIB to grant.⁵³ We do not agree. Section 48(6) does not require any particular matter to be included in rules made under paragraph (h) of section 48(2), and paragraph (h) itself does not set out any “requirements or constraints” which the rules must impose other than those which are in fact contained in Core Rule 36. Liability under section 47 is triggered by a person’s knowledge. Far from being a “general and unconditional” disapplication of offences under that section, Core Rule 36 does set out clearly the circumstances in which a person (which includes a firm) can rely on lack of knowledge (or the failure to use knowledge in the possession of one part of the firm) as a defence to those offences. It is also sufficiently flexible to allow for the fact that firms carry on business in a variety of ways and adopt very different organisational structures. It would be impractical to impose a single structure on all firms carrying on investment business.

7.24 The third respondent who disagreed with our provisional view, Dr H McVea,⁵⁴ made five points. First he suggested that since the interpretation of FSA, section 48(2)(h) is uncertain, the benefit of the doubt ought to be resolved in the favour of investors. He said that the general law offers investors greater protection than the regulatory rules, and argued that the section ought not to be construed as effecting a modification of the general law. There are various interpretative principles and presumptions that may be used in construing statutory provisions.⁵⁵ Dr McVea’s first comment appears to draw on two of these. The first is the principle that the law should not be subject to casual change⁵⁶ of these so that it should be clear that an Act was intended to amend the common law before it is interpreted as doing so; the second is the presumption that an enactment is to be given a “purposive construction”,⁵⁷ that is to say one which gives effect to the purpose of the enactment - in this case investor protection. However, an alternative presumption is the one against absurdity.⁵⁸ The interpretation we preferred in the consultation paper would avoid the absurdity that a person may be required by a rule made under section 48(2)(h) to act in a manner which necessarily breaches his common law or equitable duties.⁵⁹ Further, a purposive construction could also support this interpretation. If an overall picture is taken, the regulatory system may be regarded as enhancing investor

⁵³ Mr Berg also doubts the *Wednesbury* reasonableness of Core Rule 36.

⁵⁴ His views have since been published; H McVea, *Financial Conglomerates and the Chinese Wall - Regulating Conflicts of Interest* (1993) pp 243-244.

⁵⁵ See F A R Bennion, *Statutory Interpretation* (1992 2nd ed) Divisions Four and Five.

⁵⁶ *Ibid*, at p 561.

⁵⁷ *Ibid*, at p 659.

⁵⁸ *Ibid*, at p 679.

⁵⁹ Consultation Paper No 124, para 5.3.20 and para 7.27 below.

protection. It gives investors the benefit of active regulation and monitoring of investment business, including the exercise of investigative and enforcement powers; it also gives them compensation funds, and in the case of private investors a new statutory action for damages for breaches of regulatory rules.⁶⁰

- 7.25 Secondly, Dr McVea argued that permitting section 48(2)(h) to modify common law and equitable duties would give too much discretion to the SIB. We disagree. The powers of the SIB are restrained by Schedules 7 and 8 of the FSA which require it to promote and maintain high standards of integrity and fair dealing in the carrying on of investment business,⁶¹ and they set out standards with which the SIB's rules must comply.⁶² In any event this is a question of policy, and irrelevant to the issue of statutory interpretation.
- 7.26 His third proposition was that the difference in the position of persons authorised by RPBs and those authorised by SROs would not arise if section 48(2)(h) did not authorise the making of regulatory rules which modified common law and equitable rights and duties.⁶³ This is true, but it does not seem to us that this casts any light on the interpretation of section 48(2)(h) since that section was present in the original version of the FSA in 1986, whereas section 63A, which led to the difference in the treatment of RPBs and SROs, was not inserted until 1989.⁶⁴
- 7.27 His fourth argument was that the consultation paper, though criticising the "separate spheres of operation" argument (that regulatory rules and the general law simply operate in separate spheres)⁶⁵ in relation to section 48(2)(h) as leading to possible uncertainty, accepted it where there was no power in the statute to modify the general law. This is not entirely correct. We said that the "separate spheres of operation" argument was workable (although it might lead to confusion) in the case of section 48(2)(g) because it was possible to satisfy both the lower regulatory requirement (eg disclosure of arrangements for commission but not amount) and the more extensive requirement of the general law (eg disclosure of the amount of commission). Thus, it would not inevitably cause a conflict in the sense that

⁶⁰ FSA, s 62. See Consultation Paper No 124, paras 5.4.15, 6.8.

⁶¹ FSA, sched 7, para 5. See ss 114(1), 115(3).

⁶² FSA, sched 8. See ss 114(9)(b), 115(5).

⁶³ Rules made under FSA, s 48 do not apply to members of RPBs but can be designated to apply to members of SROs, FSA, s 63A(1). See also Consultation Paper No 124, para 5.4.22.

⁶⁴ Companies Act 1989, s 194. Before the 1989 Act came into force, the rules made under s 48 only applied to those authorised by the SIB. On désignation of certain SIB rules, see paras 5.2-5.4 above.

⁶⁵ Consultation Paper No 124, paras 5.3.19-5.3.20.

compliance with one requirement would necessarily breach the other.⁶⁶ However, in relation to section 48(2)(h), “separate spheres of operation” could lead to direct conflict between the rules and the fiduciary obligation, because a rule which “required” the withholding of information would necessarily breach the common law or equitable duty to disclose the information.⁶⁷

7.28 Finally, he argued that our provisional view on section 48(2)(h) cut against the thrust of the “double layer of law approach” which held currency among many policy makers and parliamentarians at the time of the enactment of the FSA. However, the Financial Services Bill received so many amendments in the course of its passage through Parliament that the statements made by the initial policy makers cannot be taken as a guide to the interpretation of the version which eventually was enacted as the FSA. Moreover, other sections of the FSA, sections 55 (client money) and 81 (unit trusts), cut across the “double layer of law approach” and empower the making of regulations which modify common law and equitable regulations.⁶⁸

7.29 Another, more convincing, point which came up during the course of consultation was that FSA, section 48 is limited to authorising the making of rules “regulating the conduct of investment business by authorised persons”.⁶⁹ It was said that this wording restricted the powers under the section, including that under section 48(2)(h), to the making of rules which operate in the regulatory context. On this interpretation it gives no authority for the making of rules which alter common law and equitable rights, and any difficulties of mismatch between rules made under the section and common law or equitable obligations are the result of the way the regulator chose to exercise its power. However, there are difficulties with this interpretation, since it does not address the argument outlined in paragraphs 7.19-7.20 above that if the term “enabling” is not to be deprived of meaning, section 48(2)(h) must permit the modification of the common law and equitable duty of disclosure to a customer,⁷⁰ and that a “requirement” by a regulatory rule to

⁶⁶ Consultation Paper No 124, para 5.3.19.

⁶⁷ *Ibid*, para 5.3.20. Although after *Kelly* it seems that there is unlikely to be an obligation to disclose confidential information to a customer, this was not so at the time the FSA was enacted.

⁶⁸ The Government’s white paper, *Financial Services in the United Kingdom: A New Framework for Investor Protection* (1985) Cmnd 9432 did not exclude these sections from the double layer of law approach, although they cut across it.

⁶⁹ FSA, s 48(1).

⁷⁰ It was suggested that on the restricted interpretation of s 48, customers would not fall within the expression “persons with whom [the firm] deals in the course of carrying on [part of the firm’s business]”, and that the “persons employed” are merely an example of the persons with whom the firm deals. We disagree; we think that “deals” denotes that a transaction is taking place with a third party. In our view the first part of the subsection relates to the firm withholding information from customers and other persons with whom the firm deals in the course of carrying out part of its business, and the second to the

withhold information from a customer would necessarily breach the general law duty of disclosure, unless it was modified by the section. It was also argued that the fact that by FSA, section 48(6) compliance with rules made under section 48(2)(h) is a defence to a criminal charge, but not to a breach of a civil law duty, indicated that section 48(2)(h) had a narrow effect. However, if rules made under section 48(2)(h) modify common law and equitable duties of disclosure, there is no need for a defence to an allegation of breach of a civil law duty, and the absence of one would have no bearing on the interpretation of the subsection 48(2)(h).⁷¹

- 7.30 In conclusion, we are not entirely convinced by the arguments put forward by the respondents who disagreed with our provisional interpretation of section 48(2)(h), and we still incline to the view that it probably authorises rules modifying a firm's common law or equitable duties of disclosure, and that Core Rule 36 probably has this effect. However, the range of opinions on the effect of the subsection have led us to accept that the matter is not free from doubt.⁷² In Part XVI, therefore, we consider whether Chinese walls are so essential to the operation of the financial services industry that legislative provision is required to put the matter beyond doubt.

Conclusion

- 7.31 Although many respondents questioned our provisional conclusions on each of the issues outlined in the question, none has persuaded us that our original analysis of the legal position was incorrect. The impression we have obtained is that many were influenced by the fact that since the reforms in the structure of the financial markets in the mid-1980s, and in particular the abolition in October 1986 of the Stock Exchange's single capacity requirement,⁷³ no cases have come to court in which a breach of fiduciary duty on the part of a financial services practitioner has been alleged. This has given rise to a level of reassurance about the effectiveness of the methods currently in use to modify and exclude fiduciary duties. On the other hand, we are aware of at least one case reported in the press in which such issues were raised,⁷⁴ and we are also aware of three recent Canadian cases where allegations of

withholding of information between employees for the purposes of the firm's withholding from customers etc. Our view is supported by Blair, *Financial Services - The New Core Rules* (1991) p 13.

⁷¹ See also para 7.20 above.

⁷² See also P Graham, "The Statutory Regulation of Financial Services in the United Kingdom and the Development of Chinese Walls in Managing Conflicts of Interest" in *Commercial Aspects of Trusts and Fiduciary Obligations* (McKendrick ed 1992) p 43, 52.

⁷³ See Consultation Paper No 124, para 2.2.5.

⁷⁴ In 1992 Morgan Grenfell was served with a writ by one of its former fund management clients, GPG, alleging that Morgan Grenfell had allowed its own interests to conflict with those of GPG and had failed to comply with its fiduciary duties. The claim arose because Morgan Grenfell's treasury management division acted as discretionary fund manager for GPG, while its corporate finance division was acting as lender to Egerton Trust. There was a Chinese wall between the two divisions. The treasury division purchased Egerton's

breach of fiduciary duty were raised by customers of financial services practitioners. Two of these claims were successful.⁷⁵

7.32 As we explained above,⁷⁶ we now consider that the decisions in *Kelly* and *Clark Boyce* enable contractual techniques to go a long way towards avoiding a mismatch between fiduciary duties and what is required or permitted by regulatory rules. Moreover, although the matter is not without doubt,⁷⁷ we think that there is a reasonable argument that a Chinese wall which satisfies the requirements of Core Rule 36 would, as a matter of public law, operate to modify inconsistent duties owed at common law and equity. We consider in Part XVI whether reform is required to put the matter beyond doubt.

commercial paper on GPG's behalf, and shortly afterwards, the corporate finance division called in a loan to Egerton, despite a warning from Egerton that such a move would force it to default on the commercial paper. The case raised questions about the effectiveness of Chinese walls designed to insulate the corporate finance and fund management arms of securities houses. For details see Norma Cohen, "GPG Issues Writ Against Morgan Grenfell" *Financial Times* 26 May 1992. We have no way of knowing whether this is an isolated incident or just the tip of the iceberg.

⁷⁵ *Hodgkinson v Simms* [1994] 3 SCR 377; *Bishop v Richardson Greenshields of Canada Ltd* (1993) 50 CPR (3d) 66; *Beaulieu v LOM Western Securities Ltd* (1993) 50 CPR (3d) 113. In the third case the defendant broker was found liable for breach of fiduciary duty where its employees acquired stock in an oversubscribed allotment in competition with the plaintiff customer, without making full disclosure.

⁷⁶ See paras 3.24-3.40, 7.2-7.10 above. See also paras 14.9-14.12 below.

⁷⁷ See paras 7.19-7.21 above and 16.3 below.

PART VIII

CROSSING CHINESE WALLS (Question 2)

Consultation issue

- 8.1 The second matter on which the views of respondents were sought was set out in the following terms in the consultation paper:¹

A number of questions arise out of the practice of members of firms, for instance analysts, temporarily "crossing" a Chinese wall.

(a) How necessary is it for members of firms to "cross" a Chinese wall?

(b) Does taking an analyst out of circulation until the confidential information he has learned by crossing the wall is no longer price sensitive give rise to a serious risk of indirectly communicating the nature of the information to a shrewd customer?

Our preliminary view is that, although there are undoubtedly practical difficulties in taking an analyst out of circulation, they are not so great that this method of proceeding could not for this reason alone be adopted. We believe that other ways of handling the analyst who returns to his former position, in particular confining his advice to that set out in a previously published document, are unlikely to afford an adviser a defence to an action for breach of the duty to disclose relevant information.

The necessity of "crossing" Chinese walls

- 8.2 The responses to paragraph (a) of this question revealed that it was often thought necessary and desirable for members of financial services firms to cross Chinese walls in certain defined situations. It was said that it was important that one part of a firm or group of companies should be able to call in aid the services of experts in other parts of the firm or group. The most common example was that of an industry or sectoral analyst being required to assist the corporate advisory division of a firm in connection, for example, with a public flotation or a new rights issue.² One respondent suggested that crossing walls was usually a matter of convenience rather than of necessity, because it would be too expensive to employ two experts specialising in the same sector: one to deal with investors and the other to advise companies. In practice, we think there is little difference between the two positions:

¹ Consultation Paper No 124, p 241.

² This was also revealed by the responses to our Issues Questionnaire (November 1990); Consultation Paper No 124, para 4.5.20. One respondent to the consultation paper said that analysts were commonly made insiders to brief them on the financial results of a company for whom the firm acted as broker after the markets had closed the day before an announcement about the company.

financial constraints tend to make wall crossing a matter of necessity. However, it appeared that crossing walls was less necessary in other spheres of activity, such as the provision of accountancy services.

Taking an analyst out of circulation

- 8.3 Most of the respondents who commented on paragraph (b) thought that taking an analyst out of circulation, so that he would not be able to advise customers until the confidential information which he had received was stale or part of the public domain, was an appropriate way to deal with any problems that might arise from making him an insider, although one respondent noted that this might disadvantage small firms. The point was made that it would be wrong for an analyst to continue to be held out to his customers as an independent objective expert when he had crossed over to a partisan position.
- 8.4 Respondents said that in order for the removal of an analyst from circulation to be a practical option, it was important to take care that he was not made an insider for too long before the matter on which his advice had been required, for example, a flotation, takeover or rights issue, was announced, and that, so far as possible, he was not given any information which was not going to be published (such as profit forecasts). It was noted, however, that placing an analyst "in quarantine" would nevertheless cause problems where the proposed flotation, takeover or rights issue failed to go ahead. In those circumstances the information acquired by the analyst might remain price sensitive for a long period of time, and it might not be practicable to keep him out of circulation for the extended period. A majority of those who commented on the issue whether keeping an analyst out of circulation would have a signalling effect thought that there was little risk of this.³ It was said that, in general, analysts covered several stocks, and that a customer who knew that an analyst was unavailable would be unlikely to be able to deduce from this the precise matter with which he was involved.
- 8.5 Only one respondent described other ways of handling the situation where an analyst has become an insider. It said that its policy was that an analyst could not be made an insider unless the Head of Research (who does not write research or give advice) had given permission. One of the factors which would be taken into account when granting permission was whether the analyst's normal business could be conducted if he was brought inside in relation to a particular stock. If by making him an insider his activity would need to be restricted, consideration would be given as to how the stock in question could be covered by another analyst. Because of this, this respondent said that it would be unusual for an analyst whose day to day activity covered the stock in question to be made an insider in relation to that stock for more than a day.

³ Although one respondent suggested that much would depend on the timing of the removal from circulation.

Conclusion

8.6 We accept the conclusion of most respondents that (i) it is expedient for analysts to be able to cross Chinese walls, and (ii) that provided the situation is carefully handled, so that the analyst becomes an insider only at a late stage when the transaction under consideration is firm and close to completion, and the information given to the analyst is restricted to that which will be included in the public announcement, it ought to be possible to take an analyst out of circulation until the information is in the public domain. Problems will arise, however, if confidential price sensitive information acquired by the analyst is not subsequently made public, for example, if the proposed transaction falls through, and the firm wants the analyst to return to his original duties before that information has ceased to be price sensitive. We consider that a firm that makes an analyst an insider will have to bear the risk that if the proposed transaction on which the analyst was called to advise fails to proceed, and the analyst is allowed quickly to return to his original duties, it may be liable for breach of fiduciary duty⁴ unless it has made provision to the contrary in the analyst's customers' contracts.⁵ It was our provisional view that the practice of taking an analyst out of circulation until the information he acquired is no longer price sensitive does not give rise to such a serious risk of indirectly communicating the nature of the information to a shrewd customer that it should not for this reason be adopted.⁶ This view has been confirmed by the responses on consultation.

⁴ Although the firm would not be called upon to disclose the inside information as it would be a criminal offence to do so, this does not justify the firm putting itself in a position where its obligations to the customer are compromised; see paras 3.31, 3.35 above.

⁵ See paras 3.25, 3.29, 3.39 above.

⁶ Consultation Paper No 124, para 4.5.22.

PART IX OVERLOOKING CHINESE WALLS, STOP LISTS AND WATCH LISTS (Question 3)

Consultation issue

9.1 The third question which we put to respondents was in these terms:¹

A number of questions arise out of the fact that those in managerial positions and compliance officers “overlook” a Chinese wall in the sense that their “need to know” in order to discharge their duties results in their obtaining information otherwise retained behind a Chinese wall.

(a) Is it feasible to use stop lists and watch lists as a solution?

(b) Can the inadvertent signalling effect, which may result from placing a share on a stop list, be avoided in those situations in which firms use such lists?

Summary of respondents’ views

9.2 The responses to this question indicated that stop lists and watch lists were not intended to provide a solution to any problems which might be created by management overlooking a Chinese wall (although one respondent thought they might help to overcome such problems). Watch lists and stop lists were said to be devices for monitoring the operation and effectiveness of Chinese walls, and for avoiding liability under the insider dealing legislation.² The signalling effect of watch lists was thought to be minimal, but a few respondents thought that stop lists could have a signalling effect unless a security was only placed on the list once the information about it had been made public (by which time it was said that the major period of difficulty with regard to dealings in the security would have passed). We received very few comments on the issue whether the use of such lists breached a firm’s duty to its customers, and we remain of the view expressed in the consultation paper that, unless an express contractual term permits the use of such lists, or the consent of discretionary customers is obtained, their use will risk breaching the duty to give best advice to discretionary customers.

9.3 The problem caused by management overlooking Chinese walls was not, generally, regarded by respondents as significant. It was said that senior managers who were above Chinese walls would usually only be involved in decisions of strategy and policy, and that they would not deal with customers, make markets or take decisions affecting day to day transactions. However, one respondent acknowledged that this was not always the case, and that there would be great difficulties where senior

¹ Consultation Paper No 124, pp 241-2.

² As to which see paras 2.16, 4.12 above.

managers became involved in specific cases. Another pointed out that even if senior management did not deal with customers or make markets, attribution of knowledge would cause a problem, particularly where there was a conflict between the firm's interests and those of a customer, rather than a conflict between the duties owed to two clients. It suggested that the firm would have to rely on contractual exclusions and compliance with the rules of its SRO to be completely safe. In fact, as has been explained elsewhere, Chinese walls within a single company will not prevent the attribution of knowledge irrespective of whether or not the wall is overlooked, but they may assist in dealing with the consequences of that knowledge.³

Conclusion

- 9.4 In conclusion, most respondents did not appear to consider that problems caused by management overlooking Chinese walls could be overcome by the use of stop lists and watch lists. These lists were not designed to be used for this purpose, and in the case of stop lists there could be an inadvertent signalling effect. However, most respondents did not regard management oversight as causing particular problems.

³ See paras 2.5, 3.2-3.23, 7.15 above and 12.5-12.9 below.

PART X

SHOULD FIDUCIARY LAW TAKE ACCOUNT OF REGULATORY RULES?

(Question 4)

Consultation issue

10.1 The next issue on which we invited comment was expressed in these terms:¹

Should fiduciary law take account of rules made by regulatory bodies operating in the public law sphere? Our provisional view is that it should: either because there is statutory authority for rules to modify common law and equitable obligations (as we believe to be the case in respect of FSA, sections 55 and 81 and may be the case in respect of FSA, section 48(2)(h)); or because the court should take account of reasonable regulatory rules in ascertaining the precise content of the common law or equitable duty.

We said that reasonableness was not confined to the restricted public law meaning of *Wednesbury*² reasonableness.

Summary of respondents' views

10.2 Almost all the respondents to the consultation paper thought that fiduciary law should take account of regulatory rules. Many suggested that this, the “hybrid” model set out in the consultation paper,³ might already represent the legal position. A few went even further, and said that compliance with a regulatory rule should automatically provide a defence (a “safe harbour”) to an action for breach of a fiduciary duty.

¹ Consultation Paper No 124, p 242.

² *Ibid*, paras 5.4.6 and 5.4.23. In *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1948] 1 KB 223 Lord Greene MR stated the basic principles of judicial review of discretionary powers; ie propriety of purpose, relevance of considerations taken into account, and the residual ground of “unreasonableness” or “irrationality”.

³ Consultation Paper No 124, paras 5.4.23-5.4.29.

PART XI LEGISLATIVE PROVISION THAT THE COURTS MUST TAKE ACCOUNT OF REASONABLE REGULATORY RULES (Question 5)

Consultation issue

11.1 The fifth matter which we put to respondents was in these terms:¹

Should legislation provide that the courts must take account of reasonable regulatory rules in ascertaining the precise content of common law and equitable obligations? If so:

(a) should there be legislative guidance as to what constitutes “reasonableness”,

(b) on whom should the burden of proof lie, and

(c) should “reasonableness” be determined at the time the rule was made, at the inception of the relationship between the parties, or at the time the rule is relied on?

The need for legislation

11.2 The results of consultation confirmed our provisional view that problems of mismatch between what is required or permitted by regulatory rules and the obligations imposed on fiduciaries by the common law and equity lie principally in the field of financial services.² Most of the comments made on this question, therefore, related to the regulatory rules made under the FSA regime. Respondents were divided equally between those who agreed with our provisional conclusion that there should be legislation requiring the court to take account of regulatory rules,³ those who thought that legislation was unnecessary, and those who favoured a form of legislative “safe harbour”.⁴ Those who favoured the first approach added little to the arguments set out in the consultation paper, which were mainly to the effect that there should be an acceptance that the views of regulators in an area of public law remitted to them by the legislature are entitled to some weight, but that the court should not completely abdicate control in their favour both for constitutional

¹ Consultation Paper No 124, p 242.

² *Ibid*, para 5.4.1.

³ *Ibid*, paras 7.18-7.23.

⁴ It is worth noting, however, that the majority of respondents commenting on question 1 considered that existing contractual and structural methods were in fact effective in dealing with problems of mismatch between fiduciary duties and regulatory rules; see para 7.2 above.

reasons and in order to retain the safeguard which exists at present that regulatory bodies must take account of fiduciary duties when making rules.⁵

No reform

- 11.3 The respondents who favoured the second approach included the BMBA. They thought that the courts were already likely to take into account reasonable regulatory rules and that legislation was unnecessary. We will examine in paragraphs 14.6-14.8 below whether the courts will, under the present law, take into account reasonable regulatory rules when ascertaining the content of a fiduciary duty. We conclude that they probably will, but that the matter is not entirely free from doubt.
- 11.4 The respondents who opposed reform were influenced by a number of additional factors. They pointed out, for example, that in the seven years since Big Bang and the enactment of the FSA, the relationship between fiduciary duties and regulatory rules had not caused any problems, which were not capable of private settlement. It is difficult to assess the weight to be attached to this point since, although no cases may have reached the court as yet, we have already noted⁶ that there is potential for litigation. A few respondents suggested, moreover, that the lack of disputes did not necessarily indicate that the present situation was satisfactory: it might reflect ignorance on the part of most of those affected of the fact that a fiduciary duty had been broken, or a reluctance on the part of professionals to test a Chinese wall in court.
- 11.5 More pragmatic considerations as to why legislative change was inappropriate were also put forward. The first was "regulatory fatigue". This had resulted from the many revisions to the rule books of the SROs, and the introduction of the so called "New Settlement" created under the Companies Act 1989.⁷ This has led to opposition to any additional adjustments (however small) to the regulatory environment because it is feared that this would cause further upheaval. Second, there was concern that any legislation which we might recommend would not be implemented expeditiously. If this happened, it was said that there would be an undesirable level of uncertainty in the interim period between the date of publication of the report and the date of implementation. Finally, there were fears that any legislation we recommended might be altered in the course of the parliamentary process, with the result that a proposal which might initially have merit would be amended in such a way as to make it undesirable and over-complicated.

⁵ Consultation Paper No 124, para 6.21.

⁶ See para 7.31 above.

⁷ Companies Act 1989, s 63A. See also Consultation Paper No 124, para 2.5.7.

11.6 We do not consider that the legislation suggested in the question would result in further upheaval, since it would be designed to clarify and restate the existing position, rather than create wholesale change to the regulatory environment. While we can understand the second and third considerations, our remit is to deal with the legal problem which we have identified, and we have no option but to place faith in the legislative process. In any event, we do not believe that a recommendation that there should be legislation directing the court to take account of reasonable regulatory rules in ascertaining the precise content of fiduciary obligations would increase uncertainty in the period before implementation, provided that the recommendation made it clear that the legislation was being introduced merely to clarify the present legal position.

11.7 More convincing was the objection expressed by a few respondents that it was undesirable for the court to have to reach a view on the reasonableness of the regulations in proceedings for breach of fiduciary duty, to which the regulator might not be a party. We were also concerned by the point raised by one respondent that to direct the court to take into account a regulatory rule in ascertaining the precise content of the fiduciary duty might not address the main issue. He said:

If, for example, a fiduciary sells his own property to his client he is obliged to account for any profit that he has made. If an SRO rule says that a broker dealer selling as principal must show on his contract note that he has sold as principal and must give the client best execution, how can this be relevant in ascertaining the precise content of the common law [duty]? The [common law duty] is that the fiduciary may not sell his own property to his client, in the absence of prior informed consent and, if he does, must account for any profit. The SRO's rule is undoubtedly reasonable but it does not help in ascertaining the content of the common law duty.

Although there is another solution to the example given, since there is an exception to the requirement of full disclosure where a broker sells to a customer off his own book,⁸ it suffices to illustrate the point that regulatory rules are not at present designed to address the precise content of common law and equitable fiduciary duties. Although it would be possible for the regulatory bodies to reformulate their rules to avoid this difficulty, this would be a major exercise. We consider it unrealistic to expect them to do so. Moreover, we are reluctant to recommend any reform which would require wholesale amendment of the rules, as this would result in undesirable disruption and upheaval to the regulatory environment.

11.8 These objections led us to consider another solution: that of providing a legislative defence to an action for breach of fiduciary duty where a firm has complied with a

⁸ See para 2.13, n 33 above. See also Consultation Paper No 124, paras 3.4.6, 3.4.33-3.4.34.

regulatory rule, unless it was unreasonable for the firm to have relied on the rule in the particular case, having regard to such obligations as "know your customer".⁹ However, when this solution was suggested to a selection of respondents representing those with an interest in the financial services field, it met with little favour, primarily on the grounds that there was no need for legislation because contractual techniques were thought to provide an adequate solution, and that it would not materially increase certainty. As explained in paragraphs 14.15-14.20 below we have now rejected this option.

"Safe harbour" type solutions

- 11.9 Approximately one third of the respondents to the consultation paper advocated the introduction of legislation which provided a "safe harbour", whereby compliance with a regulatory rule which permitted that which was prohibited by fiduciary law would constitute a defence to an action for breach of fiduciary duty. These respondents thought that the solution which we provisionally favoured would do little to increase certainty and was not worth pursuing. The safe harbour approach was formulated in a number of different ways. Some respondents, including, at first, the SIB,¹⁰ suggested a general safe harbour. However in addition to the problems with this approach which we set out in the consultation paper,¹¹ other respondents argued that it would be perceived as giving too much power and "carte blanche" to the regulators. Although a primary aim of the rules is to "afford investors an adequate level of protection",¹² the failures in the regulatory system exposed by events such as the Maxwell disaster which led to the Large review,¹³ the problems arising from sale of home income plans,¹⁴ and the recent complaints about mis-selling of personal pensions,¹⁵ have made it undesirable at this juncture wholly to remove customers' private law rights leaving them entirely dependent on the

⁹ SIB Statements of Principle, principle 4. See further, paras 14.13-14.16 below.

¹⁰ The SIB's view was expressed in the context that legislation was not an urgent priority.

¹¹ That it would be constitutionally inappropriate to permit the rules of self-regulatory bodies, which are not subject to direct Parliamentary safeguards, to alter common law or equitable obligations under the general law; and that it would remove the safeguard that at present rulemaking by regulatory bodies must take account of fiduciary obligations wherever possible; Consultation Paper No 124, para 6.18.

¹² FSA, ss 114(9), 115(2), 115(5). See further Consultation Paper No 124, para 2.5.6.

¹³ Large, *Financial Services Regulation - Making the Two Tier System Work* (May 1993) Foreword paras 1, 6, 23, 24; Summary paras 8 and 9; Chapter 1 paras 1.45-1.49. See also IMRO, *Submission to the House of Commons Social Security Committee* (February 1992).

¹⁴ For details see Large, *Financial Services Regulation - Making the Two Tier System Work* (May 1993), paras 1.54-1.55. See also SIB, *Annual Report 1993/94* pp 43-44.

¹⁵ See SIB, *Pension Transfers and Opt Outs, Further Safeguards for Future Business* (March 1994) and SIB, *Pension Transfers and Opt Outs: Review of Past Business* (October 1994). See also SIB, *Annual Report 1994/95* pp 5-6, 40-41.

regulatory system for protection.¹⁶ It is noteworthy that FIMBRA did not favour a safe harbour type solution and in its response to the consultation paper stated that “in the sphere of civil litigation, there has been continued reliance upon the remedies provided by the common law in total preference to the s 62 statutory right of action for damages based on a contravention of statutory or SRO rules”.

11.10 Whatever the views on the merits of a general safe harbour, it is clear that after the Large Report,¹⁷ it is no longer practical for such a solution to depend on compliance with designated Core Rules.¹⁸ We have already noted in paragraph 11.9 the difficulty of giving more power to regulators. This would be exacerbated if a safe harbour depended on compliance with the rules of an SRO which may be regarded as largely representative only of business or professional interests.¹⁹ This has led us to conclude that a safe harbour is not a viable option, and the SIB has now indicated that it no longer favours a general safe harbour: indeed, it considers that there is no need for legislation.²⁰

11.11 An alternative formulation of this approach was put forward by the Company Law Committee and described as a “modified safe harbour”. Under this option legislation would provide that, to the extent set out in a statutory instrument to be made by the Treasury, any specified fiduciary duty would be deemed to be met if a firm had complied with the specified relevant Core Rule made by the SIB. The statutory instrument would be subject to affirmative resolution of Parliament, so there would be Parliamentary safeguards. This, and the fact that the safe harbour would be restricted to Core Rules made by the SIB under a delegated power from the Treasury pursuant to FSA, section 63A, would overcome the constitutional objection to the general safe harbour.²¹ It was suggested that it could also be provided that the Treasury must be satisfied that the relevant Core Rule was framed after taking into account the general law protection which would have applied had it not been abrogated. This would avoid the second objection to the general safe

¹⁶ The same may not be true of certain specific areas, and we recommend the introduction of a safe harbour in respect of a Chinese wall which fulfils the requirements of rules made by the SIB under FSA, s 48(2)(h). See paras 16.7-16.21 below.

¹⁷ See paras 5.2-5.4 above.

¹⁸ With the exception of Core Rules 36 and 40(4)(a) and (5) these are no longer designated; the Financial Services (Dedesignation) Rules and Regulations 1994. As we have explained, the SIB has, following the Large Report, sought to act more as a standard setter and less as a formal legislator with the SROs having greater freedom to develop their own rules; see paras 5.2-5.4 above and 16.10 below.

¹⁹ Consultation Paper No 124, para 6.6.

²⁰ This is on the basis that FSA, s 48(2)(h) authorises rules which modify common law and equitable duties of disclosure and that Core Rule 36 does so (see paras 7.19-7.20 above); and that *Kelly* helps to avoid other difficulties.

²¹ See para 11.9, n 11 above.

harbour, that it would remove the incentive to take into account fiduciary duties when framing regulatory rules.²² It was not envisaged that there would be wholesale abrogation of fiduciary duties, and the Core Rules which it might be appropriate to target were said to be 2 (material interests), 3 (soft commissions), 15.2 (customers' rights), 18.2 (charges), 25 (dealing ahead of publications), and 36 (Chinese walls).

11.12 Although at first sight we were attracted by the modified safe harbour, there are two significant problems with it. The first is that it would require identification of all the practices authorised by Core Rules which might be inconsistent with fiduciary duties. Because of the large range of activities covered, it would be impossible to predict every possible scenario where mismatch between what was permitted or required by the Core Rules and by fiduciary duties would arise. If something was missed out, and an action for breach of fiduciary duty was brought where a Core Rule had been complied with, there would be a danger that a court would refuse to take the rule into account at all on the *expressio unius est exclusio alterius*²³ principle of statutory construction²⁴ because it had not been specified in a statutory instrument. Secondly, this method would rely on the exercise by the Treasury of the power to make statutory instruments. This would require the Treasury initially to identify the Core Rules which caused difficulties and the circumstances in which they did so, and then to make a policy decision as to whether it was appropriate for the rule to take precedence over the fiduciary duty in the particular circumstances. Having done so it would have to keep the situation under continuous review so that account could be taken of any changes in the Core Rules, market practice, and the regulatory climate generally. This would place a heavy burden on the Treasury. In any event, whatever the views on the merits of this proposal at the time it was made, it is no longer feasible after the Large Report, since it relies on designation of Core Rules. As has been explained above,²⁵ Large recommended that rule making be handed over, so far as possible, to the SROs, and, with the exception of Rule 36 and Rule 40(4)(a) and (b), the Core Rules have now been de-designated. The Company Law Committee has recognised that the modified safe harbour is no longer workable. In our view, it is no longer a realistic solution.

Conclusion on the main issue

11.13 None of the comments made on consultation have convinced us that our provisional view that the courts should take account of regulatory rules was incorrect. The question whether there should be legislation to this effect is more difficult to answer. A large body of consultees, including the BMBA and the SIB, considers that such

²² See para 11.2 above.

²³ "To express one thing is impliedly to exclude another".

²⁴ Bennion, *Statutory Interpretation* (2nd ed 1992) p 873.

²⁵ See paras 5.3, 11.10 above.

legislation is unnecessary. The cases of *Kelly* and *Clark Boyce* have indicated that contractual techniques can go a long way towards avoiding any problems which might be caused by mismatch between fiduciary duties and what is required or permitted by regulatory rules.²⁶ Although these considerations do not address the question of principle as to whether the regulators' views in an area of public law remitted to them by the legislature ought to be accorded some recognition by the courts, they do weigh against pursuing a recommendation which does not have the full support of those who are most likely to benefit from it. As we explain below,²⁷ we believe that a court will probably take account of regulatory rules in determining the content of a fiduciary's duties, and we do not consider that any doubts on this point justify pursuing the provisional recommendation in light of the limited support it received from consultees.²⁸ We have also been persuaded that the original formulation of the proposal, which would require the courts to pronounce on the reasonableness of a rule in proceedings to which the regulator may not be a party, is unsuitable.²⁹ Accordingly, although we were not persuaded by a number of the initial arguments put forward against reform,³⁰ and we are not as confident as some of the respondents to the consultation paper that *Kelly* provides a complete panacea to any problems created by mismatch between fiduciary duties and what is required or permitted by regulatory rules,³¹ we have decided not to recommend this solution.³²

Subsidiary issues

11.14 Since we have decided not to pursue our original proposal for legislation on the main issue, we do not intend to discuss in detail respondents' views on the subsidiary issues: whether there should be legislative guidance as to what constitutes reasonableness, on whom the burden of proof should lie, and the time when reasonableness should be determined. What follows is just a brief summary of the outcome of consultation on these matters.

²⁶ See paras 3.24-3.40 above and paras 14.9-14.12 below.

²⁷ Paras 14.6-14.8.

²⁸ We do consider, however, that in relation to the particular issue of Chinese walls reform would be desirable; see paras 16.1-16.7 below.

²⁹ As we explained in para 11.8 above, the second formulation of this approach, which would simply require the court to consider whether it was unreasonable for a firm to have relied on a rule in a particular case, also met with little favour because of the new confidence in contractual techniques.

³⁰ See paras 11.3-11.6 above.

³¹ See paras 3.31-3.32 above and paras 14.9-14.12, 14.17 below.

³² See further, paras 14.13-14.20 below.

Legislative guidance as to what constitutes reasonableness

- 11.15 Most of the respondents who commented on this issue thought that there should be no legislative guidance as to what constitutes reasonableness, primarily because of the difficulty of drafting a suitable definition, and because it was thought that guidance would restrict the court's freedom to consider all the circumstances of the case when determining questions of reasonableness. Others suggested relevant factors that the court should be directed to take into account, including the degree of protection afforded to customers by the regulatory scheme, the availability under the regulatory scheme of compensation for customers who suffer loss due to breaches of duty, the consideration whether the customer was aware of and consented to the regulatory rule in question, and the nature of the regulatory body, and in particular whether it was independent of the regulated profession. It was also suggested that guidance should not be exhaustive, but that the court should be able to consider all the circumstances of a case.

Burden of proof

- 11.16 Over three quarters of the respondents who commented on this part of the question thought that the burden of proof should be placed on the person who alleged that the regulatory rule was unreasonable. The main reason they gave was that the public law nature of the rules made it undesirable that they should be presumptively unreasonable. The respondents who thought that the burden of proof should lie on the firm were influenced by the fact that the firm would be relying on the rule to reduce its common law obligations, by the general interests of investor protection, and by the fact that the firm would generally have the resources and be in the best position to discharge the burden.

The time when reasonableness should be determined

- 11.17 Virtually all the respondents who addressed this issue thought that the reasonableness of a regulatory rule should be determined at the time it was relied upon. Two suggested that the court should also be able to consider reasonableness at the time when the rule was made, in order to cater, for example, for the situation where there was a change of circumstances but insufficient time had passed to enable the relevant rule to be revised accordingly.

PART XII OTHER LEGISLATIVE POSSIBILITIES (Question 6)

Consultation issue

12.1 The final matter we put to respondents was in these terms:¹

What other legislative possibilities should be considered, either as alternatives to that summarised in (5) above or as supplements to it? We have mentioned:

- (a) the codification of fiduciary duties,
- (b) legitimisation of generalised advanced consents,
- (c) reform of the rules on attribution of knowledge within a corporation or partnership, and
- (d) exculpation of fiduciaries who the court considers have acted honestly and reasonably.

Codification of fiduciary duties

12.2 The respondents to the consultation paper were virtually unanimous in agreeing with our provisional conclusion that codification of fiduciary duties would be impractical and undesirable.² The two consultees who were attracted by codification acknowledged that this approach would have practical difficulties. We conclude that the provisional conclusion was correct and that this option should be rejected.

Legitimation of generalised advanced consents

12.3 A majority of respondents opposed the legitimisation of generalised advanced consents for the reasons given in the consultation paper. Initially the BMBA supported this option if legislation in other areas was thought necessary. However, it has since indicated that following *Kelly* it is very confident that present contractual arrangements and disclosures are effective, and that it no longer supports reform. We consider that the provisional view was correct, and that this option should not be pursued, since legitimisation of generalised advanced consents would be unlikely to be able to distinguish between acceptable and unacceptable practices.³

¹ Consultation Paper No 124, p 243.

² Consultation Paper No 124, para 6.23.

³ Consultation Paper No 124, para 6.24.

Reform of the rules on attribution of knowledge

- 12.4 A number of respondents criticised the treatment in the consultation paper of the law on attribution of knowledge.⁴ Before examining the views expressed on reform of this area, we will consider the criticisms of our analysis of the law. We do this in four parts. First, we look at the pooling of knowledge within a company; secondly, we examine the use of confidential information by the company; thirdly, we consider the attribution of knowledge between different companies within the same group; and finally we re-cap on the impact of recent legal developments in this area.

Pooling of knowledge

- 12.5 We stated in the consultation paper⁵ that “[w]here [a] firm is a company, then as a matter of principle any matter known to part of the firm would be known by all parts of the firm; it is difficult to see any legal basis for holding that there is ‘partial ignorance’”. There are three elements to this proposition: (i) it deals with the attribution of knowledge within a company, hence statements as to what the position is in respect of a partnership are irrelevant;⁶ (ii) it assumes that the knowledge has been acquired, hence it in no way contradicts what was said in paragraph 2.3.4 of the consultation paper, since this deals with the mechanics of acquisition;⁷ (iii) it is axiomatic, in that it flows from what is taken as a principle that there cannot be partial ignorance. No one cited a case to us or a principle which would recognise the state of “partial ignorance” and no one put forward a legal argument as to how this could be the position.⁸

- 12.6 The case law dealing with attribution, as is clear from the consultation paper, is admittedly exiguous and, while it is open to more than one interpretation, we still consider that it supports our proposition. One respondent perceptively argued that *Harrods Ltd v Lemon*⁹ was not a case of “pooling of knowledge”. Instead it involved a situation where a fiduciary had conflicting fiduciary obligations to the vendor and purchaser of real property. However, Avory J at first instance said that the estate department (which acted as agent in selling the house for the vendor) and the building department (which carried out the survey for the purchaser) were not “separate entities”, and that Harrods Ltd had to be treated as “one person” in law.¹⁰

⁴ See para 2.3-2.6 above.

⁵ Consultation Paper No 124, para 2.3.6.

⁶ On partnerships, see *ibid*, para 2.3.10. See also para 2.6 above.

⁷ For a discussion on the mechanics of acquisition of knowledge by a company, see paras 2.3-2.4, 3.2-3.23, 7.14 above.

⁸ See para 7.15 above.

⁹ [1931] 2 KB 157.

¹⁰ *Ibid*, at p 162. This aspect of the decision was not dealt with on appeal but neither were the views of Avory J dissented from on this point.

It is arguable from this that as "one person" the knowledge would have been pooled.

- 12.7 Even if one accepts the more restricted interpretation of *Harrods Ltd v Lemon* put forward in the previous paragraph, namely that it is not authority for the "pooling of knowledge" between different parts of a firm in the manner we suggested, but addresses only the question of conflicting fiduciary duties, the case does not provide an answer to many of the problems which arise as a result of the different capacities in which the firm acts. There will still be many situations where there will be a conflict of interest between a firm's customers for whom it is acting¹¹ and there will also be situations where the firm itself has a conflict with the customer.¹²

Use of confidential information

- 12.8 In many situations a firm will be in possession of confidential information relating to a client which could be put to the beneficial use of other clients. As regards the use of such knowledge, we said in the consultation paper that a firm should be obliged to use all the knowledge in its possession for the benefit of a client and that "all parts of the firm must act in the light of all information possessed by the firm".¹³ Some commentators, including the BMBA, considered that this over-stated the duty on a firm to use information for a client, in that it could oblige a firm to breach a confidence owed to one client to further the interests of another client. We were persuaded by these responses that the statement in the consultation paper may have been too wide,¹⁴ and *Kelly* has subsequently confirmed that our view was indeed too wide.¹⁵

¹¹ This was the situation in *Harrods Ltd v Lemon* itself. The Court of Appeal accepted that the plaintiff may have owed conflicting fiduciary duties but held that the defendant had accepted the position with full knowledge of the facts and therefore could not resist paying the commission owed on the sale of the property. By implication, had the customer not been fully aware of and accepted the position the company may have been unable to recover the commission because of breach of its fiduciary duties in acting for both clients.

¹² One respondent said that the interpretation that we had placed on *Lloyds Bank v Savory & Co* [1933] AC 201 was too wide and it was only Lord Wright who had stated that the bank could not split up its knowledge. The real issue in that case was stated in the dissent of Lord Blanesburgh, and this was whether the bank had behaved negligently in opening the accounts in the way that it did with the result that s 82 of the Bills of Exchange Act 1882 could not be relied on. Even if this interpretation is accepted, it does not eliminate the problem, since once a duty is posited and the knowledge exists, a firm will be held to be negligent in not searching the information out in that if it had done so the relevant information can be presumed to have come to light.

¹³ Consultation Paper No 124, para 2.4.12.

¹⁴ We are not addressing here the question whether or not the firm has a contractual obligation to use such information or a duty in tort. These matters arise independently of any fiduciary duties that a firm owes to a client.

¹⁵ See paras 3.30-3.32 above.

12.9 In dealing with the effect of information in the possession of a firm three situations have to be clearly distinguished: (i) a situation where a firm has confidential information relating to client A which would be of relevance to a separate and distinct transaction involving client B; (ii) a situation where a firm has confidential information relating to client A and it would be relevant to a transaction between client A and client B in which the firm is acting; and (iii) a situation where a firm has confidential information relating to itself and is entering into a transaction with a client.¹⁶ As regards (i), as stated in the previous paragraph, the firm does not have to use the confidential information for the benefit of either client, and it is therefore possible for the firm to act for both clients.¹⁷ However, as regards (ii) and (iii), there is a conflict of interest in relation to the same matter¹⁸ and in these cases we have difficulty in seeing how the firm can act without the consent of the clients in either situation.¹⁹ Both *Harrods Ltd v Lemon*²⁰ and *North and South Trust Co v Berkeley*²¹ are examples of the type (ii) transaction and, if a fiduciary was held to be in breach of duty in this situation, it would be, *a fortiori*, in the type of transaction set out in (iii).

Groups of companies

12.10 Some respondents said that our statement of law in the consultation paper relating to the attribution of knowledge of a director who served on the boards of a parent and subsidiary company within a corporate group²² required further expansion. What we intended by this statement was that the director should have an obligation to communicate on behalf of one company and an obligation to receive on the part of the other.²³ This will depend on the facts of any given case. We said that it would be possible for a group to organise its affairs to prevent attribution from occurring,

¹⁶ One respondent considered that in dealing with attribution, a distinction needed to be drawn between information relating to the firm and information relating to the client. This distinction is undoubtedly valid, but it confuses attribution of knowledge with the use that can be made of that knowledge. Arguably it does not address the point raised in transaction (ii) in the text.

¹⁷ See para 3.30 above. However, note that if a court were to take a narrow view of *Kelly* it might hold that the firm should not have placed itself in a position where its duty to one customer conflicted with the duty owed to another; see para 3.32 above.

¹⁸ See P D Finn, "Fiduciary Law and the Modern Commercial World" in *Commercial Aspects of Trusts and Fiduciary Obligations* (McKendrick ed 1992) pp 23-27.

¹⁹ See para 3.27 above.

²⁰ [1931] 2 KB 157.

²¹ [1971] 1 WLR 470.

²² "The answer to this depends on whether the director is under an obligation to communicate the information to either entity"; Consultation Paper No 124, para 2.3.9.

²³ In fact, this analysis was in due course refined by Hoffmann LJ in *El Ajou*. See paras 3.9-3.13 above.

but suggested that this may be difficult where a director who is on the board of the parent company sits on the board of a subsidiary and overlooks a Chinese wall for the purposes of discharging his responsibilities as a member of the parent company.²⁴ The point was made by one respondent that this practice was essential for the prudent management of corporate groups, for the purpose, for example, of controlling group exposure. It was also pointed out that it would be possible to impose on the director a duty to preserve confidentiality. We agree with these points but much will depend on the particular facts of a case. If the director has received information which he has an obligation to the subsidiary to communicate and to the parent to receive,²⁵ then receipt by him will be treated as receipt by the parent.

Recent legal developments

12.11 We have already considered the legal developments which have occurred since the publication of the consultation paper.²⁶ The most significant cases with regard to attribution are *El Ajou*, *Meridian* and *Kelly*. As explained above,²⁷ the first two of these cases do not have a significant impact on the analysis of attribution in the consultation paper, although Hoffmann LJ's judgment in *El Ajou* offers a refinement of the analysis of acquisition of knowledge by reference to agency principles.²⁸ The information which was attributed to DLH because of the knowledge of Ferdman had been acquired by him in connection with his relationship with another company (the Swiss company). There was (*per* Nourse LJ) no duty owed by him to the Swiss company to communicate this knowledge to DLH and (*per* Hoffmann LJ) no duty on DLH to enquire, and therefore Ferdman's knowledge could not be attributed to DLH under agency principles. On Hoffmann LJ's analysis, even if there was a duty owed to DLH to communicate the information to it (which he thought there probably was) the presumption that Ferdman had communicated it could be rebutted as the case did not fall within one of the "distinct categories".²⁹ On the facts that presumption had been rebutted, since Millett J found that Ferdman had not communicated the information about the source of the moneys to DLH. However, the knowledge was attributed to DLH because Mr Ferdman's status

²⁴ See Consultation Paper No 124, para 2.3.9.

²⁵ Or if he comes within one of Hoffmann LJ's categories discussed at para 3.9 above.

²⁶ See Part III above.

²⁷ See paras 3.11-3.13, 3.23 above.

²⁸ Lord Hoffmann's judgment in *Meridian* also explains and refines the principles which lie behind the direct attribution of knowledge to a company by reason of a person's status.

²⁹ See para 3.9 above. These include the situation where a company has a duty to investigate which it fulfils by using an agent.

within DLH with respect to the particular transaction resulted in his knowledge being that of DLH.³⁰

12.12 As we explained earlier,³¹ Hoffmann LJ's reasoning in this case could be relevant to the situation discussed in paragraph 12.10 above, where a director sits on the board of both a parent and subsidiary company. The presumption³² that he communicated to the parent company information which he acquired as a director of the subsidiary could be rebutted so long as the circumstances did not fall within one of the "distinct categories". Further, depending on the internal arrangements within the parent company, it may be possible to prevent knowledge which he acquired as a director of the subsidiary from being directly attributed to the parent because of his status in respect of a particular transaction.³³

12.13 The third case, *Kelly*, has also been analysed fully.³⁴ The decision does not consider the principles governing the attribution of knowledge since there was actual knowledge in that case. However, it recognises that a firm is under no obligation to use confidential information relating to one client in carrying out a transaction for another client with respect to which the information is relevant.³⁵ The court singled out the case of "stockbrokers", who it considered "cannot be contractually bound to disclose to their private clients inside information disclosed to the brokers in confidence by a company for which they also act".³⁶ It is important to note that the opinion of the Privy Council is couched in terms of "not being contractually bound to disclose", and that it does not state that a fiduciary "can by contract exclude the obligation to disclose". However, as has been already observed, although the decision confirms that there is no duty to use or to disclose confidential information relating to another customer, it does not in all situations entitle the firm to put itself

³⁰ As *Meridian* makes clear it is a question of construction in each case whether the knowledge of a particular officer will be attributed directly to the company for the purpose of the particular transaction in question; see paras 3.22-3.23 above.

³¹ Para 3.13 above.

³² Such a presumption would only arise if he had a duty to communicate the information to the parent company; see para 3.10 above.

³³ For example, if he has no part in dealing with or giving advice to clients. Both *El Ajou* and *Meridian* made it clear that the question of whether knowledge will be attributed to a company because of a person's status depends on the circumstances of the particular transaction in question and the purpose of the substantive rule in respect of which the knowledge is relevant.

³⁴ See paras 3.24-3.36 above.

³⁵ See paras 3.26, 3.35 above.

³⁶ [1993] AC 205, 214. See para 3.26 above.

in a situation where it owes conflicting duties to its customers, or where its own interests conflict with those of a customer.³⁷

Views on reform

- 12.14 There was strong support on consultation for the reform of the rules on attribution of knowledge within a corporation or partnership, although some respondents commented that this would only be necessary if Chinese walls were not otherwise legitimated. In so far as there were any views on the form that the reform should take, there appeared to be a preference for a restatement of the law relating to attribution by providing clear protection where a Chinese wall had been used, although some respondents suggested that the irrebuttable presumption of knowledge should in general be replaced by a rebuttable presumption.³⁸
- 12.15 However, a small number of respondents advocated caution as regards the reform of the law relating to attribution. They were motivated by two reasons: (i) it could provide a positive and undesirable incentive for a firm to be ignorant to the detriment of its client,³⁹ and (ii) attribution is an extremely complex issue, involving as it does not only the issues addressed in the consultation paper, but also, *inter alia*, both criminal liability⁴⁰ and liability for breach of regulatory rules where knowledge is a relevant factor.
- 12.16 As regards (i), one respondent gave as an example of where this might arise the case of a broker holding client money, pending investment in a deposit account with a deposit taker with whom it had corporate links. It was suggested that the customer would expect the broker to have informed himself so far as possible as to the good standing of the deposit taker, and if the deposit taker came into financial difficulties, he would expect the broker to withdraw the funds as soon as possible. It was said that a broker who had failed to make such enquiries as any outside broker would have made should not, in these circumstances, be able to use a Chinese wall as a defence for failing to obtain the appropriate information. However, several other respondents considered that as a matter of practice the problem of wilful ignorance was one that simply did not arise.
- 12.17 As regards (ii), this is a contention with which we agree. Given that this report deals only with one facet of the attribution of knowledge to partnerships and companies, it would not be appropriate to recommend its modification without a more far ranging enquiry examining all aspects of the subject. For example, any modification

³⁷ See paras 3.27, 3.30-3.32 above.

³⁸ One response advocated the reform of s 16 of the Partnership Act 1890.

³⁹ On this see Consultation Paper No 124, para 6.26.

⁴⁰ See the brief discussion of this topic in Involuntary Manslaughter, Consultation Paper No 135, paras 4.32-4.33.

of the law on attribution would raise important questions relating to criminal and tortious liability. Answers to these difficult questions go beyond our remit in this project.

Exculpation of fiduciaries who the court considers have acted honestly and reasonably

12.18 There was almost unanimous support for a legislative provision for the exculpation of fiduciaries who, although they have breached their fiduciary duties, have acted reasonably, along the lines of section 61 of the Trustee Act 1925 and section 727 of the Companies Act 1985. It was said that in the multiplicity of circumstances in which allegations of breach of fiduciary duty could arise, a general exculpatory provision would help to reduce technical and unreasonable points being taken in the course of litigation. Even the respondents who did not favour reform on the main issue⁴¹ supported this reform. Only one respondent opposed this option. It argued that the strength of fiduciary obligations helped to ensure that regulators through their rules gave the greatest possible protection to customers, and that this strength should not be watered down by exculpatory legislation. We do not consider that this would happen. The obligations owed by a fiduciary would remain unchanged. The power would merely give the court the discretion to relieve a fiduciary of liability for breach of duty where, in its opinion, he had acted honestly and reasonably. We are inclined to the view that reform along these lines would be useful. However, for the reasons set out in paragraphs 15.2-15.12 below, we are not making a recommendation to this effect in this report.

⁴¹ That statute should provide that a court should take into account reasonable regulatory rules when considering an alleged breach of fiduciary duty. See paras 11.2-11.13 above.

SECTION D RECOMMENDATIONS

PART XIII INTRODUCTION TO FINAL RECOMMENDATIONS

- 13.1 In this section we set out our recommendations. In Part XIV, we reconsider our main provisional conclusion that statute ought to provide that account should be taken of reasonable regulatory rules when a court is ascertaining the precise content of a fiduciary obligation, and say why we are not now making a recommendation along these lines. We address in this section not only the original recommendation itself, but also a revised formulation, which we considered during the course of consultation, that there should be a statutory defence to an allegation of breach of fiduciary duty where a firm can show that it has complied with a valid regulatory rule, unless it was unreasonable for it to have done so in the particular circumstances of the case. In Part XV, we consider the merits of an exculpatory provision for fiduciaries who have breached their fiduciary duties but have acted honestly and reasonably, and explain why we do not make a recommendation for such a provision in this report. In Part XVI, we set out our recommendations regarding Chinese walls. In Part XVII, we give our recommendations on the other options for reform. Part XVIII contains a summary of our recommendations.

PART XIV RECONSIDERATION OF OUR MAIN PROVISIONAL CONCLUSION

Introduction

- 14.1 The outcome of consultation, and the legal and regulatory developments since the date of publication of the consultation paper,¹ have persuaded us not to proceed with our provisional conclusion. The focus of this part is the provision of financial services, since the responses to both the issues questionnaire² and the consultation paper³ indicate that the problems which arise out of mismatches between what is required or permitted by regulatory rules and what is required or permitted by fiduciary obligations arise primarily in this field of activity. We begin by summarising our reasons for considering that fiduciary law should take account of reasonable regulatory rules. We then examine whether this policy represents the law at present. Next we refer back to our earlier discussion of the impact of contractual techniques. We then examine our provisional recommendation for reform in the light of these considerations, and this is followed by consideration of the revised formulation of our provisional recommendation. Finally we set out our conclusions, and explain why we no longer advocate the recommendation in either its original or revised formulation.

Reasons for considering that fiduciary law should take account of reasonable regulatory rules

- 14.2 We discussed the arguments for and against the policy that fiduciary law should take account of rules made by regulatory bodies operating in the public law sphere in Part VI of the consultation paper. What follows is a summary of the three main points which have influenced our views.
- 14.3 We start with our belief that the law governing the conduct of fiduciaries should take account of the new situation⁴ which was created by the abolition of fixed commissions, the removal of the requirement of single capacity in stock-exchange transactions, and the decision to permit the development of financial conglomerates.⁵ In this new situation it is no longer realistic to follow the classic

¹ Consultation Paper No 124 (May 1992).

² Law Commission Issues Questionnaire, *Fiduciary Duties and Regulatory Rules* (November 1990). See further Consultation Paper No 124, para 1.5-1.15, Appendix 1.

³ Consultation Paper No 124.

⁴ This new situation was given statutory recognition by the enactment of the Financial Services Act 1986.

⁵ As to which see Consultation Paper No 124, section 2.2. See generally P D Finn "Fiduciary Law and the Modern Commercial World" in *Commercial Aspects of Trusts and Fiduciary Obligations* (McKendrick ed 1992) p 7.

formulations of fiduciary obligations and to require conduct which can only be achieved by a person or organisation acting in a single capacity.⁶ The regulatory system incorporates safeguards for customers, such as the requirement to obtain best execution,⁷ and it also gives customers the benefit of a pro-active system, compensation funds, and, in the case of private investors, a statutory right of action for breach of the rules.⁸

14.4 The second main point is that if the regulatory system were to operate as an additional layer of protection, leaving fiduciary obligations untouched, regulatory rules would either be required to replicate common law rules, or there would be two independent systems of law, one operating in the regulatory sphere and the other in the courts. To allow the two systems to operate side by side would be confusing, complicated and undesirable, and the retention of the second system in an unaltered form might subject people to conflicting duties.⁹

14.5 Finally, the decision to use a particular form of regulation and a particular regulatory body was a legislative one, and the regulatory bodies to whom Parliament has delegated the achievement of the new statutory purposes are likely to have expertise in the areas remitted to them.¹⁰ Thus, although the new system is described as self-regulating, it is the product of legislation and is a form of public law regulation. It is, therefore, appropriate to take some account of regulatory rules when assessing liability for an alleged breach of a fiduciary obligation.

Does this policy represent the law?

14.6 We now consider whether this policy represents the present law: whether fiduciary law does in fact take account of reasonable regulatory rules. The effect of regulatory rules on common law and equitable fiduciary duties depends on two factors: first, whether the regulator had authority to make rules which altered such duties; and secondly, if it had such authority, whether this authority was in fact exercised when the rules were made.¹¹ It is reasonably clear that FSA, sections 81(1) (unit trusts)

⁶ Consultation Paper No 124, para 6.7.

⁷ SIB Core Conduct of Business Rule 22.

⁸ FSA, s 62. See Consultation Paper No 124, para 6.8.

⁹ The main areas of potential conflict at present concern the disclosure of commission (including "soft" commission) and other remuneration, relaxation of the "no profit" rule, and the operation of Chinese walls. See para 1.8 above.

¹⁰ Consultation Paper No 124, paras 5.5.3, 7.19.

¹¹ Consultation Paper No 124, para 5.4.1.

and 55 (client money) authorise the making of rules modifying common law and equitable rights and obligations.¹² As we have discussed above,¹³ section 48(2)(h) (Chinese walls) probably also does so, but the range of different opinions on this point means that this conclusion is not free from doubt. The position is less clear, however, in relation to the other rulemaking powers in the FSA, and to the rules of the SROs and RPBs.¹⁴

14.7 We explained in the consultation paper¹⁵ that where there is a mismatch between a regulatory rule and a common law or equitable duty there are three possible outcomes. First, the court might hold that there is no authority to make such a rule and declare the rule invalid. Secondly, the court might give the rule a restrictive interpretation so that it does not affect common law and equitable duties, or operates only in the regulatory sphere. Thirdly, the court might recognise that the rule is made pursuant to statutory authority in one of two ways. It might conclude that there was authority to modify common law and equitable rights. In that case it could give the regulatory rule statutory force so that it would successfully modify the equitable right with which it is in conflict. Alternatively it could give some recognition to the public law nature of the regulatory rule by taking it into account when determining the precise content of the equitable or common law obligation.¹⁶ In each factual context the outcome will depend on the strength of the presumption that statutes do not alter the common law in the circumstances of the particular case.¹⁷

14.8 In the consultation paper we illustrated the differing strengths of the presumption by using three models. First, there was what was termed the “private law model” where the presumption was strongest. Under this, the court would hold that there was no authority to make rules altering private law rights and obligations unless the enabling statute conferred such authority expressly or by necessary implication.¹⁸ Second, there was the “public law model”, where the presumption was weakest. Under this, it is the nature and scope of the statutory scheme, rather than any express power to alter private law rights contained in the statute, that is important in determining the scope of the rulemaking powers.¹⁹ The final model, representing

¹² Consultation Paper No 124, paras 5.3.4-5.3.5.

¹³ See paras 7.19-7.30 above.

¹⁴ See generally, Consultation Paper No 124, Part V.

¹⁵ Consultation Paper No 124, para 5.4.2.

¹⁶ *Ibid*, para 5.4.3.

¹⁷ *Ibid*, para 5.4.4.

¹⁸ *Ibid*, paras 5.4.5, 5.4.8-5.4.12.

¹⁹ *Ibid*, paras 5.4.6, 5.4.13-5.4.22.

a middle way, was the “hybrid model”. Under this, some recognition would be given to the public law nature of the regulatory rule by taking account of it when determining the content of the fiduciary obligation.²⁰ Although it was our view that where the scope of a rulemaking power was uncertain, the hybrid model probably represented the law,²¹ we pointed out that this was not without doubt since the model had not been considered by the courts in the context of mismatches between regulatory rules and the common law and equity.²² The legal position has not changed since the publication of the consultation paper²³ and we still incline to the view that the hybrid model represents the law,²⁴ although there is always the risk that a court faced with a mismatch might adopt a different approach.

Impact of contractual techniques

14.9 The case for a reform of the law in order to put this point beyond doubt becomes weaker to the extent that it is possible to avoid any problems caused by a mismatch between a regulatory rule and fiduciary duty by the use of contractual techniques.²⁵ We indicated earlier²⁶ that the approach of the Privy Council in *Kelly* has confirmed the belief of many of the respondents to the consultation paper that fiduciary duties can be modified by the express or implied terms of a particular contract so as to avoid any problems of mismatch.

14.10 We have already discussed the impact of the decisions in *Kelly* and *Clark Boyce*.²⁷ We concluded that, by making it clear that an agent’s fiduciary obligations can be defined by the terms of the contract of agency, they went a long way towards enabling firms to deal with any problems which might arise as a result of mismatches between fiduciary and regulatory requirements by using the express

²⁰ *Ibid*, paras 5.4.23-5.4.29.

²¹ *Ibid*, paras 5.4.5, 5.4.8-5.4.12, 5.5.3, 6.17-6.21, 7.21-7.22.

²² *Ibid*, para 6.15.

²³ Recent cases such as *Kelly* and *Target Holdings* have, however, indicated that the courts are prepared to take a pragmatic approach to disputes which arise in the sorts of areas covered by this project and look at the commercial realities of the situation. This would tend to support the view that they will give due weight to relevant regulatory rules in an appropriate case. See para 3.40, n 72 above.

²⁴ This approach is supported by Lord Hoffmann in a speech delivered at a conference of superannuation lawyers in Australia on 24 February 1994, where he referred to the need for a “combination of moral [equitable] principle with tact in abstaining from interference where the ground is adequately covered by other rules”. In the case of rules in the financial services sphere he said that “the need for respect and restraint on the part of the courts in the interests of certainty in the market and the practical functioning of business is just as great as in the case of statutory regulation”.

²⁵ Consultation Paper No 124, para 6.10.

²⁶ See paras 7.2-7.3 above.

²⁷ See paras 3.24-3.40 above.

terms of their contracts to limit the extent of their fiduciary duties.²⁸ We said that the decision in *Kelly* also indicated that in certain circumstances, where an agency contract was silent on the matter, the fiduciary duties of an agent would be restricted by implied terms of the contract.²⁹ Finally, we considered that the Privy Council's approach lent support to the view that a trade custom which modifies a fiduciary obligation, would now be regarded as reasonable if the custom also provides adequate protection for the customer's interests.³⁰

14.11 We noted, however, that there were limitations on the extent to which *Kelly* enabled the use of contractual techniques to avoid problems of mismatch. We explained that there would be limitations on the circumstances in which the court would imply into a contract terms modifying the fiduciary duties which would otherwise be owed. We identified three situations in which the court would be unlikely to do so. The first was where a firm had acted for two customers in the same transaction.³¹ The second was where the conflict between a firm's own interest and its duty to a customer was more acute than the simple receipt of commission on a rival transaction, for example, where a firm had a direct material interest in a transaction with a customer.³² The third was where there had been "iniquity" or malpractice.³³ Beyond these three situations we said that the position would depend upon whether *Kelly* was given a wide or a narrow interpretation.³⁴ We also noted that the wide variety of Chinese walls and of the different ways in which they are monitored make it unlikely that any sufficiently certain and uniform practice can be established in relation to Chinese walls to enable the use of any particular Chinese wall to constitute a trade custom.³⁵

14.12 *Kelly* will provide a solution where the following conditions are satisfied. First, the duty defining and exclusion clause must clearly cover the transaction in question: it will have to do so unambiguously since it will be subject to the *contra proferentem* rule of interpretation.³⁶ Secondly, in those situations where the relationship between

²⁸ See paras 3.29, 3.40, 7.3 above.

²⁹ Where a firm acts for different customers with conflicting interests in different transactions, and in some circumstances where the firm's own interest conflicts with the duty owed to a customer; see paras 3.30-3.32 above.

³⁰ See paras 3.36, 7.5-7.9 above.

³¹ See paras 3.31, 7.17 above.

³² See paras 3.31, 7.17 above.

³³ See para 3.31 above.

³⁴ See para 3.32 above.

³⁵ See para 7.8 above.

³⁶ See para 2.12 above.

the firm and client has altered over time, this altered relationship will also have to be caught by the clause.³⁷ And thirdly, it must be the substance of the relationship between the client and the firm that is covered by the clause and not what the parties call it.³⁸ If these three conditions are satisfied, then *Kelly* provides a way of solving the problems that arise from any mismatch between fiduciary rules, regulatory rules and market structure.

Examination of our provisional recommendation

- 14.13 We have already reported³⁹ that although most respondents to the consultation paper thought that fiduciary law should take account of regulatory rules, support for legislation to this effect was limited. Some thought that the present state of the law was acceptable and that there was no need for reform on this issue.⁴⁰ Others thought that the only solution which would provide the necessary degree of certainty was a safe-harbour type solution whereby compliance with a relevant regulatory rule would automatically constitute a defence to a claim for breach of fiduciary duty, and when it became clear that this solution was no longer viable they preferred to have no reform at all to the middle way we had suggested.⁴¹
- 14.14 In Part XI⁴² we gave reasons why we believe that effective answers can be given to many of the arguments put forward by respondents against this option for reform. In the end, however, we were persuaded that reform along these lines might cause difficulties, both because the court might have to reach a view on the reasonableness of the regulations in proceedings for breach of fiduciary duty to which the regulator might not be a party, and also because it might require wholesale amendment of the rules of the regulatory bodies which would result in undesirable disruption and upheaval to the regulatory environment.⁴³

³⁷ See para 7.3 above.

³⁸ See paras 2.12, 3.41-3.42 above.

³⁹ See paras 10.2, 11.1-11.13 above.

⁴⁰ See paras 11.3-11.8 above.

⁴¹ See paras 11.9-11.12 above. We have already indicated why we do not favour a general "safe harbour"; see paras 11.9-11.10 above. Apart from the practical problems arising from dedesignation of the Core Rules, as a matter of principle we consider that it would be constitutionally inappropriate to permit the rules of self-regulatory bodies, which are not subject to direct Parliamentary safeguards, to alter common law and equitable obligations under the general law, and that it would remove the safeguard that at present rulemaking by regulatory bodies must take account of fiduciary obligations wherever possible. We also consider that recent publicised failures in the regulatory system have made it undesirable to remove customers' private law rights, thereby leaving them entirely dependent on the regulatory system for protection.

⁴² See para 11.6 above.

⁴³ See para 11.7 above.

Revised formulation of our provisional recommendation

- 14.15 This conclusion led us to consider other possible means of achieving the result that in an action for breach of a fiduciary duty, a court determining liability would take into account the fact that the defendant had complied with a reasonable regulatory rule. We therefore developed the idea of creating a statutory defence to an allegation of breach of fiduciary duty, if a firm could show that it had complied with a valid regulatory rule, unless it was unreasonable for it to have relied on that rule in the particular circumstances of the case.⁴⁴ We thought that it should be made clear that references to unreasonableness in this context should only encompass those situations where it would be manifestly unjust for a firm to be able to rely on a rule in the particular circumstances of a case.
- 14.16 The revised formulation of this option for reform differs from its initial formulation in the consultation paper in that it would not affect the content of the fiduciary duty in question. However, it would still achieve the intended result of protecting a firm from liability for breach of fiduciary duty if it had complied with a valid⁴⁵ regulatory rule, provided it was not unreasonable⁴⁶ for the firm to have relied on the rule. As with the initial formulation, its adoption would, therefore, ensure that a court would be able to take account of and give appropriate recognition to the expertise of the regulatory bodies in the area of public law remitted to them by the legislature, without completely abdicating control to the regulators.⁴⁷ On the other hand, the formulation of the option as a defence would have the advantage that it would avoid the difficulties to which a “taking into account” provision would give rise unless the current regulatory rules are amended.⁴⁸
- 14.17 However, when we discussed the merits of this proposal with a number of respondents, including the SIB, the Company Law Committee, and the BMBA, it was not supported. Two reasons in particular emerged from these discussions. The main reason given by a number of respondents stemmed from their confidence that market solutions, such as contractual and structural arrangements, enabled firms to deal with any mismatches between fiduciary obligations and regulatory requirements, thus obviating the need for any reform. This confidence had increased as a result of the approach of the Privy Council in *Kelly*. We have already discussed the case of *Kelly* at some length⁴⁹ and concluded that contractual techniques can go

⁴⁴ For example, when regard was had to such obligations as “know your customer”.

⁴⁵ A regulatory rule would only be valid if it satisfied the test of *Wednesbury* reasonableness (for the meaning of this, see para 10.1, n 2 above).

⁴⁶ For the meaning of “unreasonable” in this context, see para 14.15 above.

⁴⁷ See para 11.2 above and Consultation Paper No 124, para 6.21.

⁴⁸ See para 11.7 above.

⁴⁹ See paras 3.24-3.36, 14.9-14.12 above.

a long way towards avoiding a mismatch between fiduciary duties and what is required or permitted by regulatory rules, although we are not as confident as some respondents that *Kelly* provides a complete panacea to any problems which might arise as a result of such a mismatch.

14.18 The second reason put forward in the discussions was that the introduction of the defence would do little to increase certainty. Most respondents considered that where it was unclear whether a rulemaking power authorised the modification of common law and equitable obligations,⁵⁰ a court, faced with a mismatch between what is required or permitted by a regulatory rule on the one hand and by a common law or equitable fiduciary duty on the other, would give some recognition to the public law nature of the regulatory rule by taking account of it when determining the content of the fiduciary obligation, adopting the “hybrid model” outlined above.⁵¹ In other words, they were fairly confident that the court would already take into account reasonable regulatory rules. For this reason, they thought that the defence was unlikely to offer greater protection than the present law, and that it would do little to increase certainty. As we have previously indicated,⁵² we consider that where the scope of a rulemaking power is uncertain the hybrid model probably represents the present legal position, although the matter is not entirely without doubt.

14.19 Although any statutory requirement of “reasonableness” or “unreasonableness” inevitably introduces a measure of uncertainty, any uncertainty in the operation of the proposed defence would be minimised if the test of unreasonableness was formulated in such a way that it only caught extreme behaviour which gave rise to manifest injustice.⁵³ In most cases there would, therefore, be no doubt that it was reasonable for the firm to have relied on the rule, and the defence would operate. This solution would, in our opinion, provide more certainty than the present position, in which it is open to argument whether a fiduciary who has acted in accordance with a regulatory rule may (in the absence of anything in his contract to the contrary, or a reasonable trade custom, or the customer’s informed consent) nevertheless be liable for breach of a fiduciary obligation. We, therefore, believe that the concerns about uncertainty may have been overstated. As we noted in the consultation paper, commercial bodies cope satisfactorily with the “reasonableness”

⁵⁰ We are here concerned only with regulatory rules made under a rulemaking power which does not clearly authorise the modification of common law and equitable obligations. Where there is authority to modify private law rights, as there is in FSA, ss 55 and 81, (see Consultation Paper No 124, paras 5.3.4, 5.3.5, 5.4.1, 5.4.3, 5.5.2) the regulatory rule will modify the fiduciary duty and there will be no problem of mismatch.

⁵¹ See para 14.8 above.

⁵² See para 14.8 above.

⁵³ See para 14.15 above.

test⁵⁴ imposed by the UCTA regime in relation to standard written terms of business.⁵⁵ We therefore consider that the introduction of a legislative defence along the lines proposed in paragraph 14.15 above would have been useful in removing the threat of liability for breach of fiduciary duty from a fiduciary which had acted reasonably and complied with its regulatory obligations. It would have ensured a fair result where contractual techniques proved inadequate, either because of human error in drafting, or because of the difficulties of predicting rule changes in advance, or of foreseeing the potential conflicts which may arise in complex situations.

Conclusion

14.20 However, in the light of both the responses to consultation and the legal and regulatory developments since 1992 we have decided not to pursue our provisional recommendation (either in its original or its revised formulation). As we have said, a majority of respondents did not support it. We said in the consultation paper⁵⁶ that we believed that a court, faced with a mismatch between fiduciary duties and what is required or permitted by regulatory rules, would probably take account of regulatory rules in determining the content of the fiduciary duty. Although there have been no cases since then directly on this point, we believe that the approach of the courts in cases such as *Kelly* and *Target Holdings* would tend to support this conclusion.⁵⁷ We also accept that contractual techniques can go a long way towards dealing with most problems of mismatch which are likely to occur. We do not consider that, in general, the remaining difficulties and uncertainties are such that we should pursue the provisional recommendation in the light of the limited support it received on consultation. However, as we explain below,⁵⁸ in the particular case of Chinese walls we do consider that legislation is desirable to clarify the position, and we set out our recommendations on this point in Part XVI. We are also inclined to the view that it would be useful to introduce a general form of exculpatory provision,⁵⁹ an idea widely supported on consultation, but, for the reasons we give in Part XV below, we are not recommending the introduction of such a provision in this report.

⁵⁴ See Unfair Contract Terms Act 1977, ss 3, 11.

⁵⁵ Consultation Paper No 124, para 5.4.29.

⁵⁶ Consultation Paper No 124, paras 5.5.3, 7.22.

⁵⁷ See para 3.40, n 72 above.

⁵⁸ See para 16.7 below.

⁵⁹ See para 12.18 above and para 15.1 below.

PART XV

EXCULPATORY PROVISION

General

- 15.1 We gave very careful consideration to the possibility of giving the court a discretionary power to relieve from liability a fiduciary who it considers has acted honestly and reasonably and ought fairly to be excused, along the lines of section 61 of the Trustee Act 1925 and section 727 of the Companies Act 1985. This option found widespread support on consultation in relation to all spheres of fiduciary activity,¹ although it was not a proposal which was developed in the consultation paper in any detail.² At first sight it would have been a simple means of providing a safety net for a fiduciary who had complied with regulatory rules in circumstances where it was reasonable for him to have done so, but where contractual methods and public law failed to provide appropriate protection.³ It had the particular advantage of flexibility, since it would not have been tied to any particular system of regulation and would, therefore, have provided a long lasting solution. It also built on a familiar legislative technique of which the courts already have experience.⁴
- 15.2 However, when we came to examine the details of this option, and after we had discussed it further with a number of interested parties, we eventually concluded that it would not be appropriate to make a recommendation for such a provision at this stage and in the context of this report. There were, for instance, strongly opposing views on the form which such a provision should take. Some people expressed concern that the creation of a discretionary right to relief would introduce greater uncertainty than existed at present in areas of activity like financial services, and that it would lead to increased litigation and wasted costs. Others pointed out that the provision would have to be understood not only by specialist Chancery practitioners accustomed to the operation of sections 61 and 727 but by a much wider group of judges, barristers and solicitors. It was suggested, therefore, that we should spell out in very precise terms the way in which the court was to exercise its discretion. An analogy was drawn with Schedule 2 of the Unfair Contract Terms

¹ See para 12.18 above.

² See Consultation Paper No 124, para 6.28.

³ Although the exculpatory provision would not have expressly required compliance with the regulatory rules, a court would have been unlikely to exercise its discretion under the provision unless the firm had fully complied with the relevant regulatory rules.

⁴ Namely, that used in s 61 of the Trustee Act 1925 and s 727 of the Companies Act 1985.

Act 1977⁵ where the clear statements of Parliamentary intention were said to be very helpful.

Guidelines

- 15.3 This led us to consider the possibility of introducing guidelines on the meaning of the word “reasonably” and on the types of situation in which the fiduciary “ought fairly to be excused”. However, when we discussed this proposal with a number of the main parties with a specialist interest in the financial services field, they strongly opposed a provision which included any such guidelines. Two reasons were given in particular. First, it was said that it would be almost impossible to envisage all the factors which might be relevant in a given case, particularly as it was anticipated that the provision would only rarely be invoked.⁶ It was therefore important that the courts should be given as much leeway as possible. The guidelines would either be so wide and general that they would be obvious and of minimal assistance, or they would be more specific in which case there was a risk that they would fail to encompass all the situations with which a court might be confronted and could be misleading in a particular case. Secondly, it was said that guidelines would have the unfortunate effect of divorcing the new provision from sections 61 and 727. One of the advantages of an exculpatory provision which we have already noted⁷ is that it would have built on a familiar legislative technique. With the introduction of guidelines the new provision could no longer be seen as being merely an extension of existing legislation to other fields of activity, and there would be an obvious and undesirable departure from the existing provisions.

Scope

- 15.4 The second point raises other more general concerns about the introduction of a new exculpatory provision, namely what its scope should be and how it would relate to the existing legislation. On the question of scope, the issue to which this project was directed was the mismatch between fiduciary duties and regulatory rules. The responses to the consultation paper confirmed that the possibility of mismatch was not regarded as causing significant problems outside the financial services field. This suggested that the provision should only apply to fiduciaries within this field. But to limit the provision in this way would lead to considerable difficulties of definition, whether it was done by reference to the nature of the activity undertaken or the category of fiduciary involved.

⁵ Which sets out factors to be taken into account in determining whether a contractual term satisfies the requirement of reasonableness for the purposes of certain sections under the Act.

⁶ We have already indicated that we consider that any reform would be very much a safety net in the event that contractual techniques and public law failed to provide adequate protection in an appropriate case; see para 15.1 above.

⁷ See para 15.1 above.

- 15.5 For example, one option we considered was to confine the relief to breaches of fiduciary duty committed “in the course of carrying on investment business”. This would have the advantage of tying the provision to an existing definition under the FSA.⁸ However, this definition is not free from difficulties. One example given to us was the classification of bonds⁹ and loan notes.¹⁰ Although both instruments can be traded, only bonds constitute investments under the FSA.¹¹ It would be odd if exculpatory relief were available in respect of transactions involving bonds, but was unavailable in respect of those involving loan notes. The point was also made that the same transaction could involve both investment and non-investment business so that relief might be available in respect of only part of a transaction. Similar problems would arise if the provision was limited by reference to the category of person to benefit rather than by reference to the nature of the activity.¹² Whilst these difficulties of definition are present under the FSA regime and could be dealt with by careful drafting, they do demonstrate the need to consider any new exculpatory provision in a wider context.
- 15.6 Moreover, it may be regarded as anomalous that some types of fiduciary (namely trustees and directors) at present have the benefit of an exculpatory provision while others do not. There is a case for introducing an exculpatory provision which applies to fiduciaries of all kinds. The case of *Boardman v Phipps*¹³ illustrates the potential for “hard cases” which have nothing to do with a mismatch between regulatory rules and fiduciary duties.¹⁴ The court’s power to grant an equitable allowance to a fiduciary in such cases to mitigate the harshness of the equitable rules may have

⁸ See FSA, s 1(2), (3).

⁹ Bond is a generic term used to cover a wide variety of debt securities.

¹⁰ A loan note is an instrument issued in respect of money borrowed to pay for goods or services.

¹¹ See FSA, Sched 1, para 2.

¹² For example, members of RPBs such as solicitors and accountants carry out activities which in many respects are similar to those of members of SROs (eg investment and corporate finance advice) but in other respects their business can be compared to that of other professionals such as estate agents, surveyors and licensed conveyancers whose activities fall outside the FSA altogether.

¹³ [1967] 2 AC 46.

¹⁴ In that case, a solicitor who had for some time acted for the trustees of a trust purchased shares on the basis of information acquired by him while acting for the trustees. The result of the exercise, as had been intended by the solicitor, was in fact to increase greatly the value of other shares owned by the trust and he had acted in good faith throughout. Nevertheless, the solicitor was held to be a constructive trustee of the shares for the beneficiaries of the trust and liable to account to them for the profit he had made.

been cut back recently.¹⁵ In this context, the consideration of an exculpatory provision for firms operating in the financial services sector may be seen as part of a much wider problem relating to the liability of fiduciaries and the relief that is or ought to be available to them.

Relation to existing legislation

15.7 How a new provision would relate to existing legislation is another question that gives rise to difficulties. If it was thought desirable to avoid any overlap with the existing provisions then it would be necessary to exclude from the scope of the new provision those fiduciaries who are already covered by sections 61 and 727. This would not be a simple task, particularly as the exact scope of those sections themselves is unclear. For example, it is not entirely clear how far a constructive trustee can rely on section 61: although constructive trustees are included within the definition of “trustee” given in section 68(17) of the Trustee Act 1925,¹⁶ it is difficult to see how there can be a “breach of [constructive] trust” which is an essential ingredient for the application of section 61.¹⁷ There are many cases where a constructive trust will arise or be imposed where there has been a breach of fiduciary duty.¹⁸ If we were simply to exclude “trustees” from the scope of the new provision, a fiduciary who had breached his fiduciary duty and was held to be a constructive trustee might (without more) be left without any right to seek relief, since he would have been excluded from the new provision¹⁹ and might not be able to rely on the existing section 61. If, on the other hand, the new provision was to cover some of the same ground as the existing legislation, this would mean that in a particular case a fiduciary could seek to rely on the two provisions in the

¹⁵ See *Guinness v Saunders* [1990] 2 AC 663, 701 where Lord Goff stated that the exercise of the jurisdiction should be “restricted to those cases where it cannot have the effect of encouraging trustees in any way to put themselves in a position where their interests conflict with their duties as trustees”. The statements in the House of Lords in that case are in sharp contrast to those of the Court of Appeal in *O’Sullivan v Management Agency & Music Ltd* [1985] QB 428 where the defendants, who were held to have been in breach of their fiduciary duties to the plaintiff in their dealings with him, were nevertheless entitled to reasonable remuneration for the work they had done on his behalf, such remuneration to include all expenses and a “fair profit”. A liberal allowance was also given to the defendant solicitor in *Boardman v Phipps*, see n 14 above.

¹⁶ See Appendix D.

¹⁷ The full text of s 61 appears at Appendix D.

¹⁸ Where a fiduciary uses his position to obtain a benefit or where he profits in any way from a breach of his fiduciary duties he is obliged to account for the profit he has made without the informed consent of the beneficiary. But in addition he may be regarded as holding the profit (or any property which represents the profit) as constructive trustee. See *Boardman v Phipps* [1967] 2 AC 46; *Attorney General v Reid* [1994] 1 AC 324.

¹⁹ By virtue of the definition of “trustee” in s 68(17) of the Trustee Act 1925.

alternative. This could give rise to unnecessary complications, lengthen the proceedings and add to the costs.²⁰

Particular features of section 61

- 15.8 The difficulties of scope and overlap would be exacerbated if the new provision was significantly different from sections 61 and 727. This would be the case, as we have already indicated, if the new provision were to incorporate guidelines. But there are also three other features of the operation of section 61 which we consider would need reviewing in any new provision operating in the financial services field and, unless a similar review of the current legislation was carried out, differences between the old and new provisions could arise which would cause confusion and lead to an undesirable fragmentation of the law in this area.
- 15.9 The first of these features relates to “self dealing”. By this expression we mean the situation where a fiduciary buys property from or sells property to the beneficiary.²¹ In *Tito v Waddell (No 2)*²² Megarry VC held, in considering whether a claim was statute barred under the Limitation Act 1939, that self dealing was neither a breach of trust nor a breach of duty; rather he categorised it as a disability.²³ Although this case did not involve an application by a trustee for relief, this analysis does suggest that self dealing would not fall within the terms of section 61, which applies where “a trustee ... is or may be personally liable for any *breach of trust*”.²⁴ Megarry VC’s analysis was followed by Vinelott J in *Movitex Ltd v Bulfield*²⁵ when he was considering whether certain provisions in a company’s articles infringed section 205 of the Companies Act 1948.²⁶ Any new provision should be capable of covering a

²⁰ On problems of scope in relation to s 727 see *Guinness v Saunders* [1990] 2 AC 663. See n 24 below.

²¹ See Consultation Paper No 124, paras 3.4.33-3.4.36.

²² [1977] Ch 106.

²³ [1977] Ch 106, 248. In fact, in *Tito v Waddell (No 2)* Megarry VC drew a distinction between what he referred to as the *self dealing rule* and the *fair dealing rule*. The first involved the purchase by a trustee of trust property from himself and could be set aside by the beneficiary *ex debito justitiae*; the second involved the purchase by the trustee of the beneficiary’s beneficial interest and could be set aside unless the trustee could establish the propriety of the transaction. However, he categorised both rules as disabilities.

²⁴ In *Guinness v Saunders* [1990] 2 AC 663, counsel for the plaintiff referred to the self dealing rule in arguing that s 727 was not available to a director (the second defendant) who was seeking to retain a payment he had received which had not been disclosed to the full board. Neither Lord Templeman nor Lord Goff (who gave the only reasoned speeches) dealt specifically with self dealing when refusing relief.

²⁵ [1988] BCLC 104.

²⁶ This section, now s 310 of the Companies Act 1985, prohibits, *inter alia*, provisions in the articles which exempt a director from liability in respect of any “negligence, default, breach of duty or breach of trust”. The provision in the articles modified the self dealing rule and provided that a director could be interested in a contract with his company provided he

claim that, for example, a broker failed to make adequate disclosure when dealing off his book or when buying on his own account,²⁷ and in view of the uncertainty arising from the classification in *Tito v Waddell (No 2)*, this is a point which would have to be addressed in drafting the new provision.

15.10 The second feature of section 61 which would have to be considered carefully in the context of drafting a new provision concerns its application to professional trustees. Although there is no doubt about the court's jurisdiction to grant relief under section 61 to a trustee who is remunerated, there appears from the cases to be a marked reluctance to do so.²⁸ Any new provision along the lines envisaged above would be pointless unless it was in practice used to exculpate paid providers of financial services. Again, therefore, it may be necessary to make express reference to this point in any new provision.

15.11 The third feature of section 61 which would need reconsidering in any new provision is a procedural one.²⁹ We have been told by a leading Chancery practitioner that at present a trustee may seek relief at trial without having to plead particulars of his case.³⁰ We consider that this rule offends the modern practice of requiring parties to disclose their cases in advance of trial and can result in the expenditure of unnecessary costs.³¹

made disclosure of his interest in the manner required by the articles. Vinelott J held that this provision did not infringe s 205 since, as the self dealing rule imposed a disability, the provision did not involve exempting directors from liability for "breach of duty or breach of trust".

²⁷ Megarry VC's analysis would seem to include only *buying* by brokers from their customers for their own account under the fair dealing rule; *selling* by a broker off his own book would therefore come under a more general "no profit" rule. However, the cases on broker/dealers do not draw any significant distinction between buying from and selling to the customer; see the cases cited in paras 3.4.33-3.4.36 of Consultation Paper No 124.

²⁸ See the comments of Willmer LJ in *Re Pauling's Settlements Trusts* [1964] Ch 303, 338-339. See also *National Trustee Co of Australasia v General Finance Co of Australasia Ltd* [1905] AC 373; *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515. In fact, as one party with whom we raised this issue explained, "a discussion of section 61 in this context cannot practically be divorced from an analysis of the legal principles involved in the standard of care required of a trustee in dealing with the administration of a trust". A professional trustee may quite properly be expected to exercise a higher standard of diligence and knowledge than an unpaid trustee; see *Re Waterman's Will Trusts* [1952] 2 All ER 1054.

²⁹ This is also a feature of s 727 of the Companies Act 1985; see *Re Kirby's Coaches Ltd* [1991] BCC 130.

³⁰ *Singlehurst v Tapscott Steamship Co* [1899] 107 LTJ 347. See also the Note to RSC Ord 18/8/18.

³¹ This rule was criticised by Hoffmann LJ in *Re Kirby Coaches Ltd* [1991] BCC 130, 131-132.

Conclusion

15.12 These considerations have persuaded us that it would not be appropriate to recommend a new exculpatory provision for fiduciaries without carrying out a much wider review of exculpatory provisions and fiduciary duties in general, including a detailed examination of the existing legislative provisions and the position of persons such as those who intermeddle in trusts or receive trust property in breach of trust. We would need to consult fully on these difficult issues and to ensure, as far as possible, that a consistent and coherent approach was adopted. Such an exercise is outside our remit in the present project which is directed only at situations where there is a mismatch between regulatory rules and fiduciary duties. The discussions we have had with interested parties since we published the consultation paper have showed us that although there was general support for the principle of introducing an exculpatory provision, its introduction was not regarded as essential. Indeed, a limited provision incorporating guidelines was not considered to be helpful by those we consulted who had an interest in the financial services area. We have already explained³² that we consider that contractual techniques can go a long way towards dealing with any problems of mismatch which are likely to occur and that we do not consider that, in general, the remaining difficulties and uncertainties are such that we should pursue reform on the main issue in the light of the limited support received for it.³³

15.13 In conclusion, we are still inclined to the view that a form of exculpatory relief for fiduciaries along the lines of section 61 of the Trustee Act would be desirable. However, we believe that there is a much greater need to take a global look at exculpatory clauses, examining section 61 of the Trustee Act 1925 and section 727 of the Companies Act 1985 as well as the position of fiduciaries and others (such as those who intermeddle in a trust or who receive trust property in breach of trust). It is only in this way that a coherent and consistent approach to exculpatory provisions can be developed. Such an examination is outside the scope of the present project.

³² See para 14.10 above.

³³ We do, however, recommend reform in respect of Chinese walls; see Part XVI below.

PART XVI CHINESE WALLS

Introduction

- 16.1 In the consultation paper we said that Chinese walls were broadly “procedures for restricting flows of information within a firm to ensure that information which is confidential to one department is not improperly communicated (and this includes inadvertent communication) to any other department within the conglomerate”.¹ Chinese walls are widely used in the financial services sector to avoid breaches of the insider dealing legislation,² to manage or avoid conflicts between the duties owed to different customers, or conflicts between the firm’s interest and the duties owed to customers, which arise (or would otherwise arise) out of the different activities of the component parts of a firm on different sides of a wall, and to ensure the independence of the different activities of an investment house where information is already in the public domain.
- 16.2 In this part we summarise the doubts we have expressed about the effectiveness of Chinese walls as a means of managing conflicts of interest and duty, we consider the need for them in the financial services industry, and we explain how we consider that any remaining doubt should be resolved. We then examine the details of our recommendation on Chinese walls by considering in turn the definition of Chinese walls, the degree of protection which we consider should be afforded, and the persons to whom the recommendation should apply.

Doubts about the efficacy of Chinese walls

- 16.3 We said earlier³ that a Chinese wall would not prevent the attribution of knowledge between the component parts of a company (although it might do so as between different companies which form part of a group). We explained that unless appropriate provision is made in the contract between firm and customer, a Chinese wall cannot in all cases be relied upon, as a matter of private law, to limit the fiduciary duties the firm owes to the customer.⁴ We also said⁵ that although FSA, section 48(2)(h) probably authorises the making of rules which modify common law and equitable duties (that is, the duty of care imposed by the law of negligence and

¹ Consultation Paper No 124, para 4.5.1. See para 2.16 above. The main components of a Chinese wall are set out at para 2.16, n 39 above.

² See para 4.12 above.

³ Para 7.15 above. See also paras 2.5, 12.10 above.

⁴ See paras 3.34-3.35 above.

⁵ See para 7.30 above.

fiduciary duties),⁶ and that, as a matter of public law, Core Rule 36 probably does so, the matter is not absolutely beyond doubt. We conclude that there is some doubt as to the effectiveness of Chinese walls as a means of managing conflicts of interest and conflicts of duty, and that it is necessary to consider whether they are so essential to the operation of the financial services industry that this doubt should be resolved by legislation.

The need for Chinese walls

- 16.4 The responses both to our issues questionnaire⁷ and to the consultation paper⁸ indicated that Chinese walls are widely used in organisations which provide financial services, and that they are essential if the industry is to operate in its present form with multifunctional investment houses performing a wide range of services. In the consultation paper we explained how these financial conglomerates had developed after a number of reforms to the structure of the financial markets in the mid-1980s, in particular the abolition in October 1986 of the Stock Exchange's single capacity requirement that segregated broker and dealer functions, the abolition of the rules relating to outside ownership of members of the Stock Exchange, and the abolition of fixed commissions.⁹ These political and administrative decisions were given a statutory form by the enactment of the FSA.
- 16.5 As we have already said,¹⁰ in this new situation it is no longer realistic to require firms to act in a single capacity in order to avoid the possibility of breaching their fiduciary duties. In practice the new situation requires that firms must be enabled to manage and avoid conflicts by stopping information flows between departments by means of Chinese walls. This was recognised in section 48(2)(h) of the FSA and also by Core Rule 36, which attempts to accord protection to a firm which establishes a Chinese wall without its having to obtain the consent of the customer in cases where information has not passed across the wall.¹¹
- 16.6 We believe that it is essential to remove any doubts, however tenuous, about the legal efficacy of the practice of withholding information by means of a Chinese wall which complies with the regulatory requirements as a method of managing conflicts

⁶ We said in paragraph 7.20 that a firm could not be "enabled" to withhold information (as provided by FSA, s 48(2)(h)) unless there was a duty of disclosure. This argument applies just as much to an obligation to disclose or use information arising from a common law duty of care as to an obligation arising from a fiduciary duty.

⁷ Issues Questionnaire (November 1990); Consultation Paper No 124, para 4.5.2.

⁸ Consultation Paper No 124.

⁹ Consultation Paper No 124, paras 2.2.4-2.2.5.

¹⁰ See paras 14.3-14.5 above.

¹¹ See Consultation Paper No 124, para 4.5.13.

of interest and duty. The Chinese wall is an essential device for the operation of the modern financial conglomerate, and the determination of its effectiveness should not be left to the uncertainties of litigation.¹² This point was strongly emphasised by the Legal Risk Review Committee which said in its response to our consultation paper:¹³

We think that it is essential that there should be no uncertainty about the recognition of effective Chinese walls.

It is obvious that the policy to increase competition and efficiency and reduce costs by encouraging multiple capacity collides directly with traditional rules concerning the attribution of knowledge and the like. In practice, this situation can be met only by a Chinese wall. There is no doubt that reliance on Chinese walls is now entrenched in the market and there is a high degree of expectation that the law will honour the wall.

This is based upon the common-sense proposition that a fiduciary's conduct cannot be polluted or poisoned by some improper motive if the fiduciary is unaware of the other interest, whether his own or that of another client.

Resolving the doubt

- 16.7 One possible way of resolving this doubt would be to reform the rules on attribution of knowledge to provide protection where a Chinese wall is used. However, for reasons we have already given,¹⁴ we have decided that this would be inappropriate in the context of this project. The other option, which we favour, is to legislate to the effect that if a firm operates a Chinese wall which complies with relevant regulatory requirements, it shall not be regarded as being in breach of duty where (i) it withholds information from a customer (or fails to use information on his behalf) pursuant to the Chinese wall arrangement; or (ii) it places itself in a position where its own interest on one side of the Chinese wall conflicts with a duty owed to the customer of a department on the other side and as a result of the wall neither department is aware of the conflict; or (iii) it owes conflicting duties to the customers of different departments on either side of the Chinese wall and as a result of the wall neither department is aware of the conflict. As we have said,¹⁵ the expression "breach of duty" includes both the duty to take reasonable care imposed

¹² The importance attached to the Chinese wall in practice is shown by the fact that the SIB has retained Core Rule 36 as a designated rule even though it has de-designated all the other Core Rules; see para 16.10, n 25 below.

¹³ Consultation Paper No 124.

¹⁴ See paras 12.14-12.17 above.

¹⁵ See para 16.3 above.

by the law of negligence,¹⁶ and also fiduciary duties.¹⁷ Accordingly we recommend that:

There should be legislative provision that a firm shall be protected from liability where:

(i) information is withheld from a customer (or is not available for the customer's use) pursuant to a Chinese wall arrangement which complies with regulatory requirements; or

(ii) a firm places itself in a position where its own interest on one side of a Chinese wall which fulfils regulatory requirements conflicts with a duty owed to the customer of a department on the other side of the Chinese wall, and as a result of the Chinese wall neither department knows of the firm's conflicting interest; or

(iii) a firm owes conflicting duties to the customers of different departments on different sides of a Chinese wall which fulfils regulatory requirements, and as a result of the Chinese wall neither department is aware of the conflict.

Definition of Chinese walls

16.8 There is a very wide range of activities carried out by firms authorised under the FSA. Even within a particular sphere of activity, firms carry on business in a variety of ways and adopt very different organisational structures. We do not consider, therefore, that it is possible or desirable to lay down detailed statutory requirements for the structure of Chinese walls or the arrangements by which they should be monitored. We consider that these matters should be dealt with by the SIB under its delegated powers, in particular those which it has under FSA, section 48(2)(h). We have already said that we think it undesirable to give the SIB power to modify the entirety of customers' common law and equitable rights.¹⁸ Parliament has, however, recognised a structure for the operation of the financial markets which inevitably leads to breaches of some of the rules created by common law and

¹⁶ Although the scope of this project is limited to fiduciary duties, in this instance it is necessary for our recommendation to apply to duties of reasonable care because the proposed reform is intended to clarify the effect of the rulemaking power in FSA, s 48(2)(h) (see para 16.3 above) which probably permits the modification of common law and equitable duties, including duties of care imposed by the law of negligence.

¹⁷ See para 16.14 below.

¹⁸ See paras 11.9, n 11, 14.13, n 41 above.

equity.¹⁹ We do not, therefore, consider it inappropriate that the SIB should possess limited powers to modify common law and equitable rights and obligations in relation to a practice which is essential to the operation of the market structure recognised by Parliament,²⁰ and which attempts to manage or avoid the inevitable conflicts to which this structure gives rise. Chinese walls amount to such a practice. Although there may be concerns that, even in this limited area, the proposed reform would give the SIB too much discretion, we have already noted that the SIB does not have a completely free hand in rulemaking and is constrained by sections 114 and 115 and Schedules 7 and 8 of the FSA, which are designed to ensure that investors receive adequate protection, and that high standards of integrity and fair dealing are maintained in the carrying on of investment business.²¹

16.9 We consider that the solution we recommend is desirable for a number of reasons. First, it will allow the necessary flexibility since the SIB is familiar with current market practices and will be sensitive to future developments. Secondly, it is based on a power which the SIB already has and will therefore require a minimum of change to the existing regulatory structure.²² Thirdly, it will build on an already recognised practice, since the legislature has already provided expressly that effect should be given to rules of the SIB on Chinese walls outside the regulatory sphere, by providing a defence to criminal proceedings under section 47 to a firm which has complied with a rule made under section 48(2)(h).²³ Fourthly, it makes it clear that the purpose of the reform is to clarify the effect which it is likely that rules made under section 48(2)(h) already have.

16.10 We have already explained²⁴ that it would not be practicable for any general solution to the problems which we have identified to depend on compliance with designated Core Rules, since the SIB has made a policy decision to move away from detailed rulemaking and has de-designated the Core Rules. However, Core Rule 36 remains

¹⁹ See paras 14.3-14.5, 16.4-16.6 above on the decisions to abolish single capacity, the rules on outside membership of the Stock Exchange etc which were given statutory form by the enactment of the Financial Services Act 1986.

²⁰ See n 19 above.

²¹ See para 7.25 above. Similar constraints are placed on the rulemaking powers of the SROs by FSA, ss 10, 12, 13, 63A and Sched 2; see Consultation Paper No 124, paras 2.5.12-2.5.13.

²² As discussed below, it is *not* proposed to extend the new provision to persons other than those to whom rules made under FSA, s 48 can apply. See paras 16.17-16.21 below.

²³ FSA, s 48(6). See paras 7.20, 7.23 above.

²⁴ See paras 5.3, 11.10 above.

designated.²⁵ It is also likely that the SIB will have to retain a rule under section 48(2)(h), because the defence provided by FSA, section 48(6) to criminal offences under FSA, section 47²⁶ depends on compliance with such a rule. Accordingly we **recommend that:**

What constitutes a Chinese wall for the purposes of the provision should be laid down by the SIB pursuant to its delegated powers under FSA, section 48(2)(h).

- 16.11 There is, however, one aspect of the structure of the Chinese wall which we consider should be dealt with in primary legislation. We consider that it is important to make it clear in the statutory provision that only “established” arrangements will be covered. It is not intended that the statutory protection should apply to *ad hoc* arrangements within firms, which are put in place to deal with particular conflicts. We consider that such arrangements should properly be dealt with by agreement with the customer(s) concerned. Although the requirement of an established arrangement appears in the present Core Rule 36, it is not something which is set out expressly in section 48(2)(h). Accordingly we **recommend that:**

Only Chinese walls which amount to established arrangements should satisfy the requirements of the provision.

Degree of protection

- 16.12 We have already set out the three types of situation in respect of which we consider that the fiduciary should be protected.²⁷ We consider that the new provision should address only the position of Chinese walls between departments in the same legal entity and should not be extended to Chinese walls between different companies within the same group. There are two reasons for this conclusion. First, there is not the automatic attribution of knowledge between different companies within a group which we consider operates between different departments within the same legal entity.²⁸ As we have indicated,²⁹ it is open to the companies within a group to

²⁵ The Financial Services (Dedesignation) Rules 1994. In its earlier consultation document, the SIB indicated that it intended to retain Core Rule 36 as a designated rule so that firms could “continue to enjoy the statutory comfort which can be conferred by a designated SIB rule”; see SIB, *Dedesignation of The Core Conduct of Business Rules, The Client Money Regulations and The Financial Supervision Rules*, Consultative Paper 83 (August 1994), para 11.

²⁶ See para 7.23, n 52 above.

²⁷ See para 16.7 above.

²⁸ See para 7.15 above.

²⁹ See paras 2.5, 12.10 above.

organise their affairs so that attribution will not occur.³⁰ Secondly, section 48(2)(h) deals only with Chinese walls within a single legal entity,³¹ and we have already indicated that the purpose of the new provision is to clarify the effect which it is likely that rules made under that section already have.³² Accordingly we **recommend that :**

The provision should only apply in respect of Chinese walls between different departments of the same legal entity.

- 16.13 It is quite possible that part of a firm's business will not involve investment business. The firm may operate a Chinese wall which restricts the flow of information between the investment and non-investment parts of its business which complies with regulatory requirements.³³ In so far as the firm may lawfully carry on those businesses within the same entity³⁴ we consider that it should have the benefit of the statutory protection whether the claim is brought by a customer of the investment or the non-investment side of the business. In either case the information is being withheld because of a Chinese wall which complies with regulatory rules. Accordingly, **we recommend that:**

Where a person is lawfully carrying on another business in connection with his investment business, the protection afforded by the provision should apply in respect of a Chinese wall between the investment business and the connected business in the same way that it will apply to a Chinese wall between two different parts of the investment business.

- 16.14 We have also indicated that we consider that a firm should be protected from a claim for breach of common law as well as equitable duty arising from the withholding of information or from the fact of acting in the circumstances described above. This is because there may be a common law duty to use or disclose information that is quite separate from the fiduciary obligation.³⁵ However, it is only

³⁰ Although there may be limitations to this. See para 12.10 above.

³¹ FSA, s 48(2)(h) refers to the withholding of information between two parts of the business of an "authorised person" which it seems could only cover a single legal entity. See also Consultation Paper No 124, paras 5.3.17, 5.4.22. Although para 2 of Core Rule 36 does refer to groups it does not purport to have any effect outside the Core Conduct of Business Rules. Nor could it do so as it must be read in the light of FSA, s 48(2)(h).

³² See para 16.9 above.

³³ Para 1 of Core Rule 36 provides that information may be withheld between two parts of a firm's business "to the extent that the business of *one* of those parts involves investment business or associated business".

³⁴ FSA, s 48(4) provides that rules made under that section may also "regulate or prohibit the carrying on in connection with investment business of any other business".

³⁵ See paras 16.3, 16.7 above.

where liability arises for those reasons alone that the firm should be protected. The new provision is not intended to provide a defence to a claim that the firm has breached its duties or obligations in some other way. Similarly, the new provision should not interfere with any express contractual terms between a firm and its customer. If the firm has agreed expressly not to act in positions of conflict, or if it has confirmed in the contract that it has used or will use *all* the information in its possession for the benefit of its customer, it should not be able to rely on the new provision to avoid liability if it fails to fulfil the agreement it has made. On the other hand, any defence afforded by the new provision should be *in addition* to any other defences available to the firm. We have already indicated that express contractual terms can be effective in modifying the duties and obligations which would otherwise be owed by a fiduciary,³⁶ and the new provision is not intended to limit the effectiveness of such contractual techniques in any way. Accordingly we recommend that:

The protection afforded by the provision should be without prejudice to:

(i) any express contractual duties or obligations which the firm has undertaken towards its customer; and

(ii) any other defences available to the firm.

16.15 We raised the issue of “wilful ignorance” in paragraph 12.16 above, when we were discussing respondents’ views on the question whether there should be reform of the rules on attribution. We do not consider that the new provision we are proposing would give rise to the type of problem outlined in that paragraph by providing a defence, for example, to a broker who should have made enquiries and obtained the information irrespective of the Chinese wall. The broker’s failure to obtain the information in these circumstances would not have been because the firm had failed to use information in its possession *due to* the Chinese wall. It would simply be because the broker himself had failed to make normal enquiries.

16.16 A further question arises as to how the provision will operate where an analyst has been brought over the wall to advise another department in respect of a particular transaction, or where the wall is overlooked by senior management or compliance staff.³⁷ This will largely depend on whether the activity complies with the SIB rules. The requirements of the present Core Rule 36 would not be satisfied where an analyst who had crossed a wall and obtained inside information continued to advise customers in the normal way.³⁸ We consider it correct that the firm should not have

³⁶ See paras 3.29, 3.40, 14.10 above.

³⁷ See Consultation Paper No 124, paras 4.5.20-4.5.23.

³⁸ See the example given in para 3.31 above.

a defence in this situation. As discussed above,³⁹ the most appropriate way to deal with such an analyst is to remove him temporarily from his normal duties, and the firm must either make appropriate provision in its contracts with its customers, or take the risk that if the proposed transaction on which the analyst has been required to advise fails to proceed and he then returns to his normal duties, it may find that it has breached its fiduciary duties to the analyst's customers if the information which he has been given is not made public. However, we consider that the defence can and should apply to an arrangement over which there is normal oversight, provided the person overseeing the wall does not himself deal with or act on behalf of customers.⁴⁰

To whom should it apply?

16.17 We consider that the new provision should apply to all persons who may be subject to rules made under section 48(2)(h),⁴¹ that is SRO members and those regulated direct by the SIB.⁴² There are a number of reasons for limiting the provision in this way.

16.18 First, we have already indicated that it is in the financial services sphere that Chinese walls are most widely used.⁴³ The less complex nature of businesses outside this area helps to lessen any problems. Indeed, the responses to the issues questionnaire indicated that problems of mismatch between regulatory rules and fiduciary duties (including problems arising from the use of Chinese walls) were not

³⁹ Para 8.6 above.

⁴⁰ The present Core Rule 36 requires an established arrangement over which no information passes "in certain circumstances". Although the expression "certain circumstances" is not defined, we believe that it would exclude normal management and compliance oversight.

⁴¹ FSA, s 48(1) gives the SIB power to make rules regulating the conduct of investment business by "authorised persons" but expressly excludes the applicability of such rules to members of RPBs. Members of SROs and firms regulated direct by the SIB are authorised persons (under ss 7 and 25 respectively). There are other categories of authorised person, notably insurance companies (s 22), friendly societies (s 23), and operators of collective investment schemes (s 24), but the SIB's rulemaking powers have been either excluded or limited in respect of them. (See Sched 10, para 4; Sched 11, para 14; and s 86(7) respectively). There are also persons who are authorised under s 31 (that is persons authorised in another member state whose law provides "equivalent" investor protection or satisfies conditions laid down by a relevant Community instrument) who may be subject to rules under FSA, s 48(2)(h) but Core Rule 36 has not been designated to apply to them. Authorisation under s 31 is likely to be largely superseded by notification under the ISD. "Exempted" and "permitted" persons (FSA, Chapter IV and Sched 1, para 23) are outside the scope of the section as they are not "authorised persons".

⁴² The new provision is also capable of applying to persons authorised under s 31 but the present Core Rule 36 has not been designated to apply to them; see n 41 above. As previously discussed, it is envisaged that firms authorised in other member states which come within the terms of the ISD will become members or the relevant SRO for their business or be regulated direct by the SIB and may be made subject to rules made under FSA, s 48 broadly in the same way as UK authorised persons; see para 4.10 above.

⁴³ See para 16.4-16.6 above.

regarded as a significant problem outside the financial services area. Conflicts which do arise can be dealt with more easily by refusing to act in the particular situation or by making full disclosure and obtaining the client's informed consent to the firm's continuing to act.

- 16.19 Secondly, so far as RPBs are concerned, their rules tend to be much stricter than those of the SIB on the question of conflicts and the use of Chinese walls. For example, the solicitors' professional conduct rules provide that a solicitor should not accept instructions to act for two or more clients where there is a conflict or a significant risk of conflict between the interests of those two clients.⁴⁴ The guidance envisages that Chinese walls can only be used in very rare cases following the amalgamation of two firms and then only when the best interests of clients permit the amalgamated firm to continue to act and the clients have received full and frank independent advice and have subsequently consented to the arrangement.⁴⁵ The rules of actuaries⁴⁶ and insurance brokers⁴⁷ are also stricter. It would be undesirable if a firm could rely on the less strict SIB rule as a defence to civil proceedings even though it had breached its own professional conduct rules.
- 16.20 Finally, the use of Chinese walls by members of SROs and firms authorised by the SIB has already been accepted by section 48(2)(h). This was as a result of a conscious policy decision to allow such firms to operate as multifunctional financial conglomerates. Our recommendation is aimed at clarifying the law in respect of this

⁴⁴ The Guide to the Professional Conduct of Solicitors (1993), Rule 15.01. For a general discussion of the position under the earlier 1990 edition of the Guide, see Consultation Paper No 124, paras 5.3.30-5.3.35.

⁴⁵ The Guide to the Professional Conduct of Solicitors, Annex 15A.

⁴⁶ There is no provision in the Memorandum on Professional Conduct (March 1993) expressly permitting the use of Chinese walls. Para 8 states that if there is or might be a conflict of interest the actuary must consider the extent to which it is proper for him to continue to act. If he is satisfied that it is, he should only do so after he has made full disclosure to the client of the conflict.

⁴⁷ The new Code is set out in the schedule to the Insurance Brokers Registration Council (Code of Conduct) Approval Order 1994, SI 1994 No 2569. There is no provision in relation to Chinese walls and para 2(4) requires brokers placed in a position of conflict to withdraw from the matter unless, after full disclosure, all the relevant parties agree in writing that they should continue to act. See also generally, Consultation Paper No 124, para 5.3.38.

provision,⁴⁸ and we do not seek to extend it beyond what is strictly necessary for the proper functioning of the financial services markets.⁴⁹

16.21 The particular position of accountants merits some further consideration. Use of Chinese walls by them does appear to be more widespread than by members of other RPBs. There are a number of very large firms which carry out a range of activities (eg audit, corporate finance, insolvency services) where there is potential for conflicts between the interests of different clients or between the interests of the firm and a client. However, these conflict situations are likely to be relatively simple and predictable (compared to the situations which arise in multifunctional finance houses). It should therefore be possible for them to be dealt with by using a combination of the contractual and disclosure methods discussed above. The Institute of Chartered Accountants stressed in its response to the issues questionnaire⁵⁰ and to the consultation paper⁵¹ that the notification to and agreement by the client is a fundamental element in the steps to be taken to deal with any conflict of interest. This is a perfectly satisfactory procedure for dealing with conflicts. Accordingly we recommend that:

The provision should apply to those persons who are subject to rules made under FSA, section 48(2)(h).

⁴⁸ Although rules made under FSA, s 48(2)(h) can only be designated to apply to firms which are authorised by membership of an SRO or by the SIB, they are commonly regarded as giving protection from criminal liability under FSA, s 47 to any person whether or not so authorised. This is because FSA, s 48(6), which provides the defence, simply refers to things done "in conformity with" rules made under FSA, s 48(2)(h). Our recommendation is not intended to affect the position in respect of FSA, s 48(6) in any way.

⁴⁹ So far as other authorised firms are concerned and those who are exempt or permitted persons, the types of business which they undertake and the capacities in which they act are generally more limited. The responses to the issues questionnaire indicated that those seeking to carry out a wider range of activities would often become members of the relevant SRO(s) for their businesses.

⁵⁰ Law Commission Issues Questionnaire, *Fiduciary Duties and Regulatory Rules* (November 1990); See Consultation Paper No 124, paras 1.5-1.15, Appendix 1.

⁵¹ Consultation Paper No 124.

PART XVII

OTHER OPTIONS FOR REFORM

Reform of the rules on attribution of knowledge

- 17.1 We explained in paragraph 12.17 above that it would be inappropriate in the context of the limited sphere of this project to recommend modification of the rules on attribution of knowledge to partnerships and companies. We have, therefore, decided not to recommend any reform of this area of the law.

Codification of fiduciary duties

- 17.2 The outcome of consultation¹ confirmed our provisional conclusion that it would be impractical and undesirable to attempt to codify fiduciary duties.² Accordingly, we do not recommend that this option for reform should be pursued.

Legitimation of generalised advanced consents

- 17.3 There was little support on consultation for the legitimation of generalised advanced consents.³ As was stated in the consultation paper, a general legislative legitimation of clauses might not adequately distinguish between acceptable and unacceptable practices.⁴ Also, it is now clear that the scope of a firm's fiduciary duties can be defined by the terms of its contract with the customer.⁵ This means that generalised disclosures made in the contract will be effective provided that the contract clearly delimits the fiduciary duties owed to the customer and displaces the obligation to make full disclosure of all material facts. We, therefore, confirm our provisional view and recommend that this option should be rejected.

¹ See para 12.2 above.

² Consultation Paper No 124, para 6.23.

³ See para 12.3 above.

⁴ Consultation Paper No 124, para 6.24.

⁵ See paras 3.29, 3.40, 7.3 above.

PART XVIII

SUMMARY OF RECOMMENDATIONS

- 18.1 There should be legislative provision that a firm shall be protected from liability where:
- (i) information is withheld from a customer (or is not available for the customer's use) pursuant to a Chinese wall arrangement which complies with regulatory requirements; or
 - (ii) a firm places itself in a position where its own interest on one side of a Chinese wall which fulfils regulatory requirements conflicts with a duty owed to the customer of a department on the other side of the Chinese wall, and as a result of the Chinese wall neither department knows of the firm's conflicting interest; or
 - (iii) a firm owes conflicting duties to the customers of different departments on different sides of a Chinese wall which fulfils regulatory requirements, and as a result of the Chinese wall neither department is aware of the conflict (para 16.7).
- 18.2 What constitutes a Chinese wall for the purposes of the provision should be laid down by the SIB pursuant to its delegated powers under FSA, section 48(2)(h) (para 16.10).
- 18.3 Only Chinese walls which amount to established arrangements should satisfy the requirements of the provision (para 16.11).
- 18.4 The provision should only apply in respect of Chinese walls between different departments of the same legal entity (para 16.12).
- 18.5 Where a person is lawfully carrying on another business in connection with his investment business, the protection afforded by the provision should apply in respect of a Chinese wall between the investment business and the connected business in the same way that it will apply to a Chinese wall between two different parts of the investment business (para 16.13).
- 18.6 The protection afforded by the provision should be without prejudice to:
- (i) any express contractual duties or obligations which the firm has undertaken towards its customer; and
 - (ii) any other defences available to the firm (para 16.14).

18.7 The provision should apply to those persons who are subject to rules made under FSA, section 48(2)(h) (para 16.21).

(Signed) HENRY BROOKE, *Chairman*
ANDREW BURROWS
DIANA FABER
CHARLES HARPUM
STEPHEN SILBER

MICHAEL SAYERS, *Secretary*

1 November 1995

APPENDIX A

Draft Financial Services (Amendment) Bill

ARRANGEMENT OF CLAUSES

Clause

1. Clarification of effect of s 48(2)(h) of 1986 Act.
2. Short title and extent.

DRAFT
OF A
B I L L

TO

Clarify the effect of section 48(2)(h) of the Financial Services Act 1986. A.D. 1995.

BE IT ENACTED by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:—

- 5 1.—(1) A person who is subject to rules made under section 48(2)(h) of the Financial Services Act 1986 (withholding of information as between different parts of a person's business) incurs no liability to a person with whom he deals in the course of carrying on his investment business—
- 10 (a) for failing to make information in his possession available to, or to use such information for the benefit of, that person; or
- (b) for failing, by not availing himself of such information, to avoid a conflict of interest between himself and that person or between that and another person with whom he deals in the course of
- 15 carrying on his investment business,
- if he shows that the failure is due to established arrangements made by him which comply with the provisions of the rules.
- (2) Where a person who is subject to those rules lawfully carries on another business in connection with his investment business subsection
- 20 (1) above shall apply to him as if references in that subsection to a person with whom he deals in the course of carrying on his investment business were references to a person with whom he deals in the course of carrying on either of those businesses.
- (3) Subsection (1) above—
- 25 (a) does not exonerate a person if he has expressly agreed that all information in his possession is to be made available or used by him as mentioned in that subsection or that any such conflict of interest as is there mentioned is to be avoided by him; and
- (b) is without prejudice to any defence available apart from that
- 30 subsection.

Clarification of effect of s.48(2)(h) of 1986 Act.

EXPLANATORY NOTES

Clause 1 implements the Commission's recommendation to clarify the effect of section 48(2)(h) of the Financial Services Act 1986 (withholding of information as between different parts of a person's business). It gives statutory protection to a firm which operates an established Chinese wall arrangement which complies with rules made by The Securities and Investments Board pursuant to its delegated powers under section 48(2)(h).

Subsection (1) sets out the types of claim in respect of which the firm is to have the benefit of the statutory protection. These comprise not only the failure to disclose or use information in the firm's possession but also the failure to avoid acting in a conflict situation where the failure is due to the Chinese wall and where the firm is dealing with the customer (or both customers in the case of a conflict between the duties owed to two customers) in the course of carrying on investment business.

Subsection (2) extends the statutory protection to situations where the firm is dealing with the customer (or one of them where there is a conflict between the duties owed to two customers) in the course of carrying on other business in connection with the firm's investment business.

Subsection (3) is included to make it clear that the statutory protection has no effect on any express agreement which the firm has entered into with a customer nor on any other defences available to the firm in respect of a claim by the customer.

(4) References in subsection (1) above to rules made under section 48(2)(h) of the 1986 Act includes references to any further provision made for the purposes of the matters there mentioned by rules made by virtue of section 48(3).

(5) The provisions of this section shall be deemed always to have had effect. 5

Short title and
extent.

2.—(1) This Act may be cited as the Financial Services (Amendment) Act 1995.

(2) [Extent].

EXPLANATORY NOTES

Subsection (4) is included to make it clear that the rules with which the Chinese wall must comply include not only those made under section 48(2)(h) itself but also any rules making further provision on the matter under section 48(3).

Subsection (5) makes it clear that the provision is to have retrospective effect. The purpose of the bill is to clarify the effect that rules made under section 48(2)(h) have always had.

Clause 2 contains the short title and extent of the bill. It makes no provision for extent because the Law Commission cannot make recommendations for Northern Ireland and Scotland but, as the Financial Services Act 1986 extends beyond England and Wales, consideration should be given to extending the provision to these jurisdictions to achieve a consistent approach.

APPENDIX B

Relevant extracts from the Financial Services Act 1986

SECTION 47

- (1) Any person who-
- (a) makes a statement, promise or forecast which he knows to be misleading, false or deceptive or dishonestly conceals any material facts; or
 - (b) recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive,

is guilty of an offence if he makes the statement, promise or forecast or conceals the facts for the purpose of inducing, or is reckless as to whether it may induce, another person (whether or not the person to whom the statement, promise or forecast is made or from whom the facts are concealed) to enter or offer to enter into, or to refrain from entering or offering to enter into, an investment agreement or to exercise, or refrain from exercising, any rights conferred by an investment.

- (2) Any person who does any act or engages in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any investments is guilty of an offence if he does so for the purpose of creating that impression and of thereby inducing another person to acquire, dispose of, subscribe for or underwrite those investments or to refrain from doing so or to exercise, or refrain from exercising, any rights conferred by those investments.

....

SECTION 48

- (1) The Secretary of State may make rules regulating the conduct of investment business by authorised persons but those rules shall not apply to persons certified by a recognised professional body in respect of investment business in the carrying on of which they are subject to the rules of the body.

- (2) Rules made under this section may in particular make provision-
- (h) enabling or requiring information obtained by an authorised person in the course of carrying on one part of his business to be withheld by him from persons with whom he deals in the course of carrying on another part and for that purpose enabling or requiring persons employed in one part of that business to withhold information from those employed in another part;

....

(3) Subsection (2) above is without prejudice to the generality of subsection (1) above and accordingly rules under this section may make provision for matters other than those mentioned in subsection (2) or further provision as to any of the matters there mentioned except that they shall not impose limits on the amount or value of commissions or other inducements paid or provided in connection with investment business.

....

(6) Nothing done in conformity with rules made under paragraph (h) of subsection (2) above shall be regarded as a contravention of section 47 above.

....

APPENDIX C

Core Rule 36

1. Where a firm maintains an established arrangement which requires information obtained by the firm in the course of carrying on one part of its business of any kind to be withheld in certain circumstances from persons with whom it deals in the course of carrying on another part of its business of any kind, then in those circumstances:

- a. that information may be withheld; and
- b. for that purpose, persons employed in the first part may withhold information from those employed in the second;

but only to the extent that the business of one of those parts involves investment business or associated business.

2. Information may also be withheld where this is required by an established arrangement between different parts of the business (of any kind) of a group, but this provision does not affect any requirement to transmit information which may arise apart from the Core Conduct of Business Rules.

3. Where the Core Conduct of Business Rules apply only if a firm acts with knowledge, the firm is not for the purposes of the Core Conduct of Business Rules to be taken to act with knowledge if none of the relevant individuals involved on behalf of the firm acts with knowledge.

4. In addition, in order to avoid the attribution of information held within a firm to that firm for the purposes of section 47 of the Act, the effect of section 48(6) of the Act is that nothing done in conformity with paragraph (1) of the core rule on Chinese walls is to be regarded as a contravention of section 47 of the Act.

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APPENDIX D

Relevant extracts from the Trustee Act 1925

SECTION 61

If it appears to the court that a trustee, whether appointed by the court or otherwise, is or may be personally liable for any breach of trust, whether the transaction alleged to be a breach of trust occurred before or after the commencement of this Act, but has acted honestly and reasonably, and ought fairly to be excused for the breach of trust and for omitting to obtain the directions of the court in the matter in which he committed such breach, then the court may relieve him either wholly or partly from personal liability for the same.

SECTION 68

In this Act, unless the context otherwise requires, the following expressions have the meanings hereby assigned to them respectively, that is to say:-

....

(17) "Trust" does not include the duties incident to an estate conveyed by way of mortgage, but with this exception the expressions "trust" and "trustee" extend to implied and constructive trusts, and to cases where the trustee has a beneficial interest in the trust property, and to the duties incident to the office of a personal representative, and "trustee" where the context admits, includes a personal representative, and "new trustee" includes an additional trustee;

....

APPENDIX E

List of persons and organisations who commented on Consultation Paper No 124

JUDICIARY AND PRACTITIONERS

(i) Judiciary

Judge Paul Baker QC
Lord Browne-Wilkinson
Mr Justice Campbell
Lord Jauncey of Tullichettle
Judge Peter Mason QC
Lord Justice Staughton

(ii) Barristers

Ian Geering QC (London Common Law & Commercial Bar Association)
Edwin Glasgow QC

(iii) Solicitors

W R Aldwinckle (Linklaters & Paines)
A G J Berg (Watson Farley Williams)
Cameron Markby Hewitt
Clifford Chance
D Hunter (Blythe Liggins)
L P Kehoe (Grant Thornton)
A D Kennedy (Beachcroft Stanleys)
Lovell White Durrant
M McKee (Clifford Chance)
J R Millar (Bischoff & Co)
Paul Phillips (Allen & Overy)
Simpson Curtis
Travers Smith Braithwaite
E I Walker-Arnott (Herbert Smith)
P R Wood (Allen & Overy)

(iv) Legal Organisations

General Council of the Bar - Bar Council Law Reform Committee
The Law Society
The Law Society of Scotland
The Law Society's Standing Committee on Company Law
Legal Risk Review Committee

(v) Other Lawyers

Sir Wilfrid Bourne QC, KCB

ACADEMIC LAWYERS

A Alcock, University of Buckingham

Dr G Bean, University of Warwick

Professor J R Birds, Unit for Commercial Law Studies, University of Sheffield

D A V Boyle, Centre for Management Studies, University of Exeter

Professor S M Cretney QC, All Souls College, University of Oxford

Professor R Flannigan, University of Saskatchewan

Professor P Latimer, Monash University

Dr H McVea, University of Bristol

Professor A C Page, University of Dundee

Dr R M Thomas, Centre for Business & Public Sector Ethics

COMMERCIAL ORGANISATIONS

(i) Banks

Barclays Bank plc

Barclays de Zoete Wedd Ltd

Baring Brothers & Co Ltd

Charterhouse plc

Chase Manhattan Trustees Ltd

C Crouch (Robert Fleming & Co Ltd)

Penelope Curtis (N M Rothschild & Sons Ltd)

Hambros Bank Ltd

Hill Samuel Bank Ltd

James Capel & Co Ltd

Kleinwort Benson Ltd

M H Legge (Charterhouse Bank Ltd)

Lloyds Bank plc

R Pattimore (Scandinavian Bank Ltd)

Royal Bank of Scotland plc

Schroders Ltd

UBS Phillips & Drew Ltd

S G Warburg Group plc

Yamaichi International Ltd

(ii) Other Financial Services Companies

D O Brown (Independent Financial Advisory Centre)

G P Hagland (Albert E Sharp & Co)

M Harty (Credit Lyonnais Capital Markets plc)

Hoare Govett Ltd

Kleinwort Benson Investment Management Ltd

Mercury Asset Management plc

Thamesway Investment Services Ltd

(iii) Accountants

Ernst & Young
KPMG Peat Marwick
P F Green (Grant Thornton)
Price Waterhouse

(iv) Insurance

Pearl Assurance plc

REPRESENTATIVE BODIES

Association of British Insurers
British Bankers' Association
British Merchant Banking and Securities Houses Association
City Capital Markets Committee
The Committee of Scottish Clearing Banks
Confederation of British Industry
Friendly Societies Liaison Committee
Institute of Chartered Accountants in England and Wales
Institute of Chartered Secretaries & Administrators
Institute of Investment Management and Research
Institutional Fund Managers' Association
Joint Exchanges Committee
Life Insurance Association
National Association of Estate Agents
Royal Institution of Chartered Surveyors
Society of Pension Consultants
The UK Association of Compliance Officers

EXCHANGES

London Fox
London Metal Exchange
London Stock Exchange
R Rambridge (International Petroleum Exchange)

REGULATORY BODIES

Bank of England
Financial Intermediaries, Managers and Brokers Regulatory Association
Investment Management Regulatory Organisation Ltd
The Investment Ombudsman
The Securities and Futures Authority Ltd
The Securities and Investments Board

GOVERNMENT BODIES

Office of Fair Trading

Public Trust Office
Serious Fraud Office

OTHER

C M Johnston

J Mitchell (International Consumer Policy Bureau)

J R Sheldon

A C Suretees (Reviewer of Complaints for the Institute of Chartered Accountants)

APPENDIX F

List of those who attended the Oxford seminar (see para 1.13)

THE LAW COMMISSION

The Honourable Mr Justice Brooke

Professor Jack Beatson

Ros Innes

Nicholas Cox

Professor Dan Prentice (Consultant to the Commission)

THE SECURITIES AND INVESTMENTS BOARD

Michael Blair

Jane Welch

TREASURY

Paula Diggle

Jane Stokes

BRITISH MERCHANT BANKING AND SECURITIES HOUSES ASSOCIATION (now the London Investment Banking Association)

Colin Condren

Kit Farrow

John Mayo

THE LAW SOCIETY'S STANDING COMMITTEE ON COMPANY LAW

Tim Herrington

Paul Nelson

BANK OF ENGLAND

Peter Peddie

APPENDIX G

List of others who have assisted with the project

Mads Andenas

Mrs Justice Arden

Lord Justice Balcombe

Colin Bamford, Financial Law Panel

William Blair QC

Martin Chester, The Law Society's Standing Committee on Company Law

Professor Hugh Collins

Professor Ross Cranston

Lord Justice Peter Gibson

Peter Graham, The Law Society's Standing Committee on Company Law

Mr Justice Harman

Michael Hart QC

Lord Hoffmann of Chedworth

Christopher Jarman, Payne Hicks Beach

Mr Justice Knox

Leslie Kosmin QC

Richard McCombe QC

Lord Justice Morritt

Paul Newman

Robert Reid QC

Daniel Schaffer, Freshfields

Sir Richard Scott VC

Mr Justice Walker

Giles Wintle, Institute of Chartered Accountants in England and Wales

Derrick Wyatt



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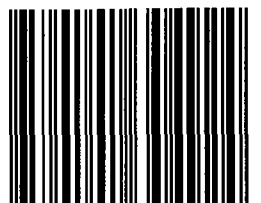
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