PROFESSIONAL RESPONSIBILITIES AND FIDUCIARY OBLIGATIONS OF SECURITIES BROKERS

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I. INTRODUCTION

The activities undertaken by a securities broker which is a member of Australian Stock Exchange Limited ('ASX') are likely to include buying and selling securities on the Exchange on behalf of its clients; providing investment advice in relation to listed and other securities; acting as an underwriter on the placement or new issue of securities by listed companies; operating managed investment portfolios for clients; and holding securities in the name of the broker's nominee company on behalf of its clients. The activities undertaken by brokers obviously involve the exercise of skill and the application of specialist knowledge. Brokers are subject to occupational regulation, in that they are required to meet admission standards prior to obtaining membership of the ASX and are required to meet continuing conduct obligations while they remain members of the ASX. Each of these features is characteristic of a profession.[1]

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1 As to the characteristics of a profession, see *Currie v Inland Revenue Commissioners* [1921] 2 KB 332 at 343; RM Jackson and JL Powell, *Professional Negligence* (1987) p 1.

The application of regulatory controls to securities brokers, whether under the licensing regime established by the *Corporations Law* or under the Business Rules of ASX, and the imposition of civil liability upon brokers at common law and by statute, can be supported by reference to the need to ensure that brokers act to promote a fair and orderly market in order to promote investor confidence. Given the complexity of investment in the securities market - involving judgments as to anticipated returns and levels of investment risk, whether in relation to particular stocks or an investor's portfolio generally - the client of a securities broker is not necessarily competent to assess whether advice given by the broker and dealings undertaken on the client's behalf are in the best interests of the client or are consistent with industry standards.[2] Moreover, a broker is likely to have the ability to insure against loss more readily than an individual client. The purchase of professional indemnity insurance by a broking firm, the cost of which is spread among all clients of the broker, operates as a means of spreading the risk of loss among traders in the securities markets who use brokers' services.[3]

Admission requirements under the *ASX Articles of Association*, and licensing of securities dealers under the *Corporations Law*, together impose a threshold control over the admission of persons to the securities industry. Part 7.3 Division 1 of the *Corporations Law* provides for the licensing of dealers and investment advisers. Section 780 of the *Corporations Law* prohibits a person from carrying on or holding itself out to carry on a "securities business" unless the person holds a dealers licence[4] or is an exempt dealer. The term "securities business" is defined in s 93(1) as "a business of dealing in securities". The term "deal" is in turn widely defined in s 9. Obviously, a broking firm can be said to be carrying on a business so as to fall within the licensing requirements.[5]

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2 The NCSC Discussion Paper titled *A Review of the Licensing Provisions of the Securities Industry Act and Codes* (1985) para [5.10] noted that investors depend upon securities professionals for the quality of advice given; for the absence of bias in advice and for the resolution of conflicts of interest in favour of the investor; for custody of investor property; and for the absence of fraud and unacceptable practices by the dealer.

3 *Ibid*, para [5.7] P Latimer, "Regulation of Securities Industry Intermediaries - Australian Proposals", (1987) *University of Pennsylvania Journal of International Business Law* 1 at 5; TS Lodge & DJ McCauley, "Walking the tightrope: the comprehensive liabilities of securities professionals in the United States" (1980) 5 *Journal of Comparative Business and Capital Market Law* 267 at 269-270.

4 The terms 'dealers license' and 'investment advisers license' are used here without an apostrophe as they are terms defined in the Corporations Law (see s 9).

5 *Ballantyne v Raphael* (1889) 15 VLR 538; *Hyde v Sullivan* (1956) 56 SR(NSW) 113; *Hungier v Grace* (1972) 127 CLR 210 per Barwick CJ at 217; *FCT v St. Hubert's Island Pty Limited* (1978) 138 CLR 210 per Jacobs J at 237; *United Dominions Corporation Ltd v Brian Pty Ltd* (1985) 157 CLR 1 per Dawson J at 15; R Baxt et al, *Stock Markets and the Securities Industry* (3rd ed, 1988) paras [1002] [1212]; JM Kriewaldt, "Investment Advice - Licensing

Articles 36 and 37 of the *ASX Articles of Association* require the ASX Board to be satisfied of certain matters prior to admitting a natural person or corporation to membership of ASX.[6]

A broker is subject to obligations at common law, including a duty to use reasonable care and skill in carrying out its client's instructions and a duty to make the best possible bargain for its client within the limits set by those instructions. A broker which is instructed to buy or sell shares acts as agent for its client and is therefore under a fiduciary obligation to avoid situations of conflict between its interests and those of its client, and not to compete with its client in trading on its own account. The professional responsibilities of securities brokers are reinforced by legislative intervention. Part 7.3 Division 3 of the *Corporations Law* is directed to the conduct of representatives of dealers and investment advisers. Part 7.3 Division 4 provides for the liability of dealers and investment advisers for conduct of their representatives. Part 7.3 Division 5 provides for the exclusion of persons from the securities industry. The *ASX Business Rules* also deal with a number of aspects of the conduct of the business of securities brokers, establishing prudential requirements as to the capital of Exchange members; establishing requirements as to the keeping of records, accounts and auditing of the broker's business; detailing the means of effecting transactions upon automated trading systems, the settlement procedures applicable to such transactions and the reporting obligations of brokers; and specifying the procedures to be adopted by for 'buying-in' securities where the seller fails to deliver the securities.

Part II of this article discusses the scope of brokers' duties at contract and tort, while Part III deals with brokers' duties in equity. Part IV deals with financial conditions and accounting requirements imposed on brokers under Chapter 7 of the *Corporations Law* and under the *ASX Business Rules*. Part V deals with conduct of business requirements under the *Corporations Law* and under the *ASX Business Rules*, and examines the extent of a broker's personal liability to other brokers and to its clients and the rights of a buying or selling broker against its clients. That Part also briefly refers to the operation of the National Guarantee Fund. Part VI deals with standards of market conduct, including the restrictions on principal trading by brokers; brokers' obligations as to the order in which they execute transactions; the prohibition on transactions involving a fraud on the market; the prohibition on 'churning', or undertaking

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and Liability: Licensing Issues", *BLEC Seminar on Securities Market Regulation*, 1988, pp 4-5; *Australian Corporation Law*, paras [7.1.1160] - [7.1.1170].

6 The imposition of membership standards was a matter emphasised in ASX's submission to the Trade Practices Commission, which argued that it was in the public interest that ASX adopt standards allowing it to "satisfy itself that the persons who manage/control a Member Organization have the necessary knowledge, skill and experience to conduct their business in a manner which is honest, efficient and fair and are of good fame and character". Trade Practices Commission, Final Determination, May 1987 (1987) ATPR (Com) 50-053, para 21.

excessive transactions so as to generate commission income; the limits on trading by employees of broking firms; and the obligation to maintain a register of securities. Part VII deals with the obligations of brokers as to recommendations made to their clients, including the obligation to disclose an interest of the broker in the subject matter of the recommendation and to have a reasonable basis for the recommendation. Part VIII deals with liability of brokers for the conduct of their representatives. Part IX deals with exclusion from the securities industry.

II. BROKERS' DUTIES AT COMMON LAW

Under American law, the 'shingle theory' states that "even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public".[7] In *Charles Hughes & Co v SEC*,[8] the Court relied on the shingle theory in upholding a finding that a securities dealer who had sold securities to his customers at prices exceeding their market value and without disclosing that value had breached an implied representation that he would deal fairly with his customers. In *Hanly v SEC*,[9] the Court endorsed a version of the shingle theory in observing that a securities dealer "occupies a special relationship to the buyer of securities in that by his profession he impliedly represents he has an adequate basis for the opinions he renders." That the dealer conducts a business in securities is itself sufficient to give rise to that implied representation.

Under the shingle theory as applied in American law, a broker-dealer may be found liable for imposing unreasonable mark-ups in the price of securities or selling securities at prices not reasonably related to the price prevailing in the open market; engaging in high pressure sales techniques; executing unauthorised transactions in its client's account or undertaking excessive transactions so as to generate commission income ('churning'); failing to properly execute a client's order; or failing to disclose material information to a client. The shingle theory is said to give rise to an implied representation that securities recommended by a broker-dealer are suitable to the customer's financial condition and investment objectives. It follows that a broker-dealer has an obligation to be informed about a security and about its customer in order to have a reasonable basis for making a recommendation to purchase the

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7 L Loss, *Fundamentals of Securities Regulation* (2nd ed, 1988) p 813; MI Steinberg, *Understanding Securities Law* (1989) p 147; RW Jennings & H Marsh, *Securities Regulation: Cases and Materials* (6th ed. 1987) pp 625-626.

8 139 F 2d 434 (2d Cir 1943).

9 415 F 2d 589 at 596-597 (2d Cir 1969).

security to the customer.[10] If a broker does not disclose the breach of an implied representation arising under the shingle theory, the broker may be held liable under American law for breach of Rule 10b-5 made under the *Securities Exchange Act* 1934 (US).

Under Australian law, a broker is under a duty to use reasonable care and skill in carrying out its client's instructions. If a broker acts in accordance with its client's instructions and its legal obligations, it is entitled to be indemnified by its client for liability arising out of the transaction.[11] If a broker fails to act in accordance with its client's instructions, at common law it may lose the right to recover commission and lose the right to an indemnity from the client for liabilities which it has incurred. A broker is also under a duty to make the best possible bargain for its client, within the limits set by its client's instructions. At common law, a broker may be under further duties to make a valid and enforceable contract; to act honestly and to observe the rules, usages and market practices of the Exchange; to keep its clients' property separate from its own property; and to keep proper accounts to enable its clients' property to be recorded accurately.[12]

A. THE TERMS OF THE CONTRACT BETWEEN A BROKER AND ITS CLIENT

The scope of a broker's duties to its client in contract depends upon the terms of the contract.[13] Any additional contractual obligation imposed upon the broker, beyond the express terms of its engagement, must be implied on the

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10 RW Jennings and H Marsh, note 7 *supra*, p 651; RA Hibbard "Private Suits Against Broker-Dealers: A Proposal to Limit the Availability of Rescissory Relief for Misrepresentations Implied by the Shingle Theory" (1975) 13 *Harv J on Legislation* 1 and Nichols "The Broker's Duty to his Customer under Evolving Federal Fiduciary and Suitability Standards" (1977) 26 *Buffalo LR* 435; Note, "Broker-Dealers, Market Makers and Fiduciary Duties" (1978) 9 *Loyola U Chi LJ* 746; Comment, "Private Actions under the Suitability and Supervision Duties of Exchange and Dealer Association Rules: The Fraud Requirement" (1979) 16 *San Diego LR* 773; Note "The Suitability Rule: Should a Private Right of Action Exist?" (1981) 55 *St Johns LR* 493; C Scott "A Broker-Dealer's Civil Liability to Investor for Fraud: an Implied Private Right of Action under Section 15(c)(1) of the Securities Exchange Act of 1934" (1988) 63 *Indiana LJ* 687.

11 The broker's right of indemnity at common law is confirmed by the ASX Business Rules, which allow the broker to resell securities purchased on behalf of a buying client if the client defaults in payment, and to buy in securities to satisfy its delivery obligations at the client's cost if the client fails to deliver scrip sold on the client's behalf.

12 G Cooper & RJ Cridlan, *Law and Procedure of the Stock Exchange*, 1971; MG Hains, "Duties and Obligations of a Futures Broker to his Client" (1987) 3:2 *Aust Bar Rev* 122 at 126-128; *Australian Corporation Law*, 1991, para [7.2.0030].

13 *Midland Bank Trust Co Ltd v Hett, Stubbs & Kemp* [1979] Ch 384 at 402-403; *Hawkins v Clayton* (1988) 164 CLR 539 per Mason CJ and Wilson J at 544.

basis that it is necessary to give business efficacy to the contract between broker and client and is so obvious that it goes without saying. Any such term must be reasonable and equitable; capable of clear expression; and must not contradict the express terms of the contract between the broker and its client.[14] The existence of a general duty to exercise reasonable care, skill and diligence imposed upon a broker under the law of negligence will tend against implying a contractual term to the same effect.[15] In situations where a broker is simply instructed by its client to execute a particular transaction, it is unlikely that a contractual term would be implied to the effect that the broker was required to also offer investment advice.[16] Such a term is not necessary for the business efficacy of the contract, particularly if a client requires execution services from a broker rather than advisory services and negotiates a lower commission rate on that basis.

The customs of the stock exchange are incorporated into the contract between the broker and its client, provided that such customs are notorious, certain and reasonable. This proposition is an application of the principle that a person who employs a dealer in a specialised market is taken to authorise the dealer to act according to the established usages of that market, if the usages of the market are sufficiently well-known.[17] For example, in *Jones v Canavan*,[18] Jacobs JA concluded that the custom and usage which permitted a broker to cross orders, without seeking the specific consent of its client to do so, was reasonable and should be recognised by the Courts.[19] In *Con-Stan Industries of Australia Pty Ltd v Norwich Winterthur Insurance (Australia) Ltd*,[20] the High Court noted that the existence of a custom or usage is a question of fact.[21] There must be evidence that the custom is notorious, although not necessarily universal, in the sense that it is so well known and accepted that everyone making a contract in the relevant circumstances can reasonably be presumed to have imported that term into the contract. The custom cannot contravene the express terms of the agreement. A person may be bound by the custom although he or she was not aware of it, since knowledge will be imputed if the custom is sufficiently

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14 *BP Refinery (Westenport) Pty Ltd v Shire of Hastings* (1978) 52 ALJR 20; *Codelfa Constructions Pty Ltd v State Rail Authority of NSW* (1982) 56 ALJR 459.

15 *Hawkins v Clayton*, note 13 *supra* per Deane J at 573-574.

16 SW Scherer, "The Stockbrokers' Duty of Care in the US and UK" (1985) 6 *Company Lawyer* 3 (Part 1), 164 (Part 2), 215 (Part 3) at 164.

17 P Latimer, "Stock Exchange Usage" (1990) 8 *C&SLJ* 165 at 168.

18 [1972] 2 NSWLR 236.

19 *Ibid* at 243.

20 (1986) 160 CLR 226 at 236-238.

21 The requirements of evidence relating to the existence of a custom are set out in *Nelson v Dahl* (1879) 12 Ch D 568 per Jessel MR at 575, applied in *Thornley v Tilly* (1925) 36 CLR 1 per Knox CJ at 8 and in *Majeau Carrying Co Pty Ltd v Coastal Rutile Pty Ltd* (1973) 129 CLR 48 per Stephen J at 60-61.

notorious. It will be sufficient to establish a custom if there is credible evidence by one or more persons in the relevant trade who assert in general terms that the custom exists.[22] In *FAI Traders Insurance Company Ltd v ANZ McCaughan Securities Ltd*,[23] Cole J held that incorporation of a custom into the contract between a broker and its client required that "repetitive acts demonstrating the usage must be proved by instance or generality; the usage must be notorious; and it must be uniform and reasonable."[24]

The rules of the relevant stock exchange are also incorporated by reference in contracts between clients and brokers.[25] Section 842 of the *Corporations Law* requires a broker to send a contract note to its client, if a transaction takes place in the ordinary course of business on a stock market and the broker acted as agent for the client. Section 842(6)(b) provides that, for the purposes of s 842, a transaction takes place in the ordinary course of business on a stock market if it takes place in prescribed circumstances. Regulation 7.4.03 of the *Corporations Law* in turn provides that a transaction takes place in prescribed circumstances, for the purposes of s 842(6), if it takes place at an official meeting of a securities exchange in Australia between persons who are members of the securities exchange. If the transaction does not take place in the ordinary course of business and the broker entered the transaction as agent for a client, the broker is required to send the contract note both to its client and to the person with whom the broker entered the transaction. Rule 3.8(2) of the *ASX Business Rules* in turn requires the contract note which a broker sends to its client to have printed upon it that it is issued subject to the Articles, Rules and Regulations, customs and usages of the Exchange. The reference to the 'Rules' of the Exchange in the terms of the contract note raises matters of considerable difficulty. It seems that the term 'Rules' used in Article 3.8(2) and on the face of a contract note issued by a broker to a client has the meaning given by the *ASX Articles of Association*.[26] Article 1(2) of the *ASX Articles of Association* in turn provides that "Rules" means "rules made by the Board under Articles 70 or 71 and includes the regulations made by the Board of the subsidiary." In *FAI Traders Insurance Company Ltd v ANZ McCaughan Securities Ltd*,[27] Cole J held that the terms of the contract note issued by a broker under Rule 3.8 incorporated not only the Business Rules of ASX but also the *ASX Listing Rules*. That decision has significant practical implications for brokers. If the Listing Rules are incorporated in dealings between brokers and listed company

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22 *Walton v Maher*, unreported, Court of Appeal of the Supreme Court of New South Wales, 9 October 1975 per Mahoney JA (with whom Street CJ and Samuels JA agreed) at 79-82.

23 (1990) 3 ACSR 279; 9 ACLC 84

24 *Ibid* at ACSR 306.

25 *W Noall & Son v Wan* [1970] VR 683.

26 For the reasoning which supports that conclusion, see *Australian Corporation Law*, para [7.1.0805].

27 Note 23 *supra*.

clients by the terms of the contract note issued to the client and function as a condition precedent to the obligations established under that contract note, it follows that a listed company is not obliged to complete a contract with a broker if entry into the transaction involves a breach of the Listing Rules by that listed company, even if the breach of the Listing Rules is capable of waiver by ASX and even if the broker is wholly innocent of the breach.

There is authority that, where a client instructs his or her broker to buy or sell securities on ASX, it is an implied term of the agency contract between the client and the broker that the client is bound by the *ASX Business Rules* to the extent that they establish the manner in which a contract for the sale and purchase of securities is formed on the Exchange and the incidents of such a contract. In *Bonds & Securities (Trading) Pty Ltd v Glomex Mines NL*,[28] Street J followed earlier authority that the rules and usages of the exchange are admissible and relevant to determining the terms of the contractual relationship between the buyer and seller of shares, since the course of business in dealings on the Stock Exchange provided the context in which the contractual relationship between the parties was to be determined. In *Bell Group Limited v The Herald and Weekly Times Limited*[29] Kaye J held that, in instructing a broker to conduct a transaction on the Exchange, a client authorises the broker to conduct the transaction according to the rules and regulations of the Exchange and the client submits himself or herself to those rules and regulations.[30] His Honour further held that, in order to give business efficacy to a transaction between a broker and its client, a term could be implied into the contract to the effect that the client is bound by all Articles, Rules and Regulations of the Exchange which prescribe the manner of formation of a contract for the sale and purchase of a security. His Honour held that a broker's client cannot acquire any rights as buyer or seller of securities from a transaction on the Exchange until a contract has been concluded in conformity with the Articles, Rules and Regulations of the Exchange. The decisions in *Bonds & Securities (Trading) Pty Ltd v Glomex Mines NL* and *Bell Group Limited v The Herald and Weekly Times Limited* were followed by Cole J in *Tag Pacific Limited v Bos Stockbroking Ltd.*[31] Cole J there held that the *ASX Business Rules* were incorporated into the contact between the broker and its client since the standard form contact note had been issued by the broker in prior transactions with that client, and that the Business Rules had the effect that payment made by a purchaser to the selling broker was received by the selling broker as agent for the seller, rather than being held by the selling broker on trust for the purchaser until paid to the seller.[32]

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28 [1971] 1 NSWLR 879.

29 (1985) 9 ACLR 697 at 702, [1985] VR 613.

30 His Honour cited *Harker v Edwards* (1887) 57 LJ QB 147 as authority for that proposition.

31 (1989) 15 ACLR 337.

32 *Ibid* 339.

Conversely, it appears that the broker is under a contractual obligation to its client to comply with the rules and regulations of ASX in relation to the purchase or sale of securities. In *Nevitts Ltd v Cooper*,[33] Boulton J noted that *Bell Group Ltd v The Herald & Weekly Times Ltd*[34] was authority that the agency contract between principal and broker impliedly contained the relevant rules and regulations of the Stock Exchange. His Honour held that it was a necessary corollary to the proposition that the client was impliedly bound to observe the relevant Articles, Rules and Regulations of the Exchange as part of its contract with the broker, that the broker was bound to do likewise as part of the agency contract.

B. BROKERS' DULY TO USE REASONABLE CARE AND SKILL

A broker may be held liable for loss suffered by its client under the law of negligence. By analogy with the duty of care imposed upon professionals generally, a broker is obliged to exercise due care, skill and diligence. Although the broker is not required to have an extraordinary level of skill or the highest professional attainments, it must bring to its task the competence that is usual among persons practising as brokers.[35] The question of whether a broker has breached the duty of care owed to its client is a question of fact, which must be answered in a particular case by reference to the standard or measure of care which is reasonable in the circumstances. Evidence of the practice of brokers will not necessarily be determinative of the conduct necessary to discharge a broker's obligations under the duty of care owed to its client, whether in tort or in contract, although it may provide a "sound guide to what is reasonable."[36]

In *Stafford v Conti Commodity Services Ltd*,[37] which was an action in negligence brought against a commodities broker, Mocatta J treated the duties owed by a commodities broker as analogous to those owed by a securities broker. His Honour noted that a broker had no duty to offer advice or offer recommendations, but would be held to a duty to exercise reasonable care and skill if it did so. His Honour held that the fact that a client suffers loss as a result of relying on advice given by a broker does not in itself give rise to an inference of negligence on the part of the broker. He observed that "in such an unpredictable market as this, it would require exceedingly strong evidence from expert brokers in relation to individual transactions to establish negligence."[38] Although the market for listed securities is generally less volatile than the

33 (1988) 10 Qld Lawyer Reps 40.

34 Note 29 *supra*.

35 *Voli v Inglewood Shire Council* (1963) 110 CLR 74 per Windeyer J at 84.

36 *Pacific Acceptance Corporation Ltd v Forsayth* (1970) 92 WN(NSW) 29 per Moffitt P at 74; *Midland Bank v Hett, Stubbs & Kemp* [1979] 1 Ch 384 at 402; *Edward Wang Ltd v Johnson, Stokes* [1984] AC 296 at 306.

37 [1981] 1 All ER 691.

38 *Ibid* at 698.

commodities markets, a fall in the value of securities is not necessarily predictable by a person exercising due care and diligence. It follows that the principle of *res ipsa loquitur* should not be applied in an action against a broker for negligent investment advice so as to require the broker to prove the absence of negligence.

Earlier authority suggested that a broker would not be liable for investment advice given gratuitously, if the broker acted negligently but in good faith. In *Schweder v Walton*,[39] the Court held that a broker which gratuitously volunteered investment advice was under a duty to give that advice bona fide, but was under no duty to investigate its accuracy. That case involved a dealing between two brokers, one of which was acting as agent for the other, in circumstances where each would have been aware of the factors which might affect the market prices of shares and where the element of reliance on the advice offered by the broker may have been absent. To the extent that the decision cannot be distinguished on that basis, it is inconsistent with subsequent authority holding that a professional who offers advice gratuitously is under a duty to exercise the care and skill which would be exercised by a competent person practising in that profession.[40] The decisions in *Hedley Byrne v Heller*[41] and *MLC v Evatt*[42] establish that a broker which holds itself out as having special skill and expertise, in offering investment advice to clients or potential clients, is liable in negligence for losses resulting from its client's reliance on statements made by the broker without reasonable care. In *Hedley Byrne*,[43] Lord Reid observed that a person who offered advice in circumstances that he knew that his advice would be relied upon, and did so without a qualification that he accepted no responsibility for the advice, must be "held to have accepted some responsibility for his answer being given carefully, or to have accepted a relationship with the inquirer which requires him to exercise such care as the circumstances require."[44] In *MLC v Evatt*,[45] Barwick CJ expressed the view that liability for negligent misrepresentation could arise from the making of such a representation by a person who possessed particular expertise in circumstances that the information could reasonably be acted upon by another person, who might suffer financial loss as a result.[46] Although the Privy Council took a narrower view in *MLC v Evatt*,[47] the reasoning of Barwick

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39 (1910) 27 TLR 89.

40 Note 16 *supra* at 164; G Cooper and RJ Cridlan, note 12 *supra*, p 134.

41 [1964] AC 464.

42 (1968) 42 ALJR 316 (High Court); [1971] AC 793 (Privy Council).

43 Note 41 *supra*.

44 *Ibid* 503.

45 Note 42 *supra* (High Court).

46 *Ibid* 321.

47 Note 42 *supra* (Privy Council).

CJ has been adopted by the High Court in *Shaddock v Parramatta City Council*[48] and *San Sebastian Pty Ltd v Minister*.[49]

The class of persons to whom a broker owes a duty of care in offering investment advice is limited by the requirement of proximity.[50] The existence of a professional relationship between a broker and its client, combined with the client's reliance on the broker's exercise of its professional skills and the forseeability of economic loss to the client if the broker fails to exercise due care and skill, will generally be sufficient to create the necessary relationship of proximity between a broker which offers investment advice and a client who suffers economic loss by acting on that advice.[51] The extent of advice which a broker is required to offer its client, in exercising a reasonable degree of care and skill, will depend in part on the extent of the client's existing understanding of the securities market.[52] To the extent that the broker's liability for investment advice arises under *Hedley Byrne*,[53] the broker is generally able to avoid that liability by use of a disclaimer which makes clear that it does not accept responsibility for any advice which it offers.[54] Although the imposition of liability in negligence no doubt tends to discourage brokers from offering gratuitous investment advice, at least without disclaiming liability for such advice, the imposition of liability may be supported on the ground that a broker is likely to have a higher degree of skill and knowledge in relation to the securities markets than the majority of its clients.

The common law duty to exercise reasonable care and skill owed by a broker to its client is reinforced by s 74 of the *Trade Practices Act* 1974 (Cth), which implies a term in contracts for the supply of services to a consumer that the services will be rendered with due care and skill. Where the purpose of seeking services or the result which is desired from those services is made known to the provider of the services, a term is also implied that the services will be reasonably fit for that purpose or are of such a quality that might reasonably be expected to achieve that result. Broadly speaking, a person is a consumer for the purposes of s 74 of the *Trade Practices Act* if the price of the services does not exceed $40,000 or if the services are of a kind usually purchased for personal or household use. It may be, for example, that services provided by a broker to an institutional client would not fall within the latter category.

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48 (1981) 150 CLR 225.

49 (1986) 162 CLR 340.

50 *Id.*

51 *Council of the Shire of Sutherland v Heyman* (1985) 157 CLR 424 per Deane J at 497; *Hawkins v Clayton*, note 13 *supra* per Deane J at 576; *Waimond Pty Ltd v Byrne* (1989) 18 NSWLR 642; GR Masel, *Professional Negligence of Lawyers, Accountants, Bankers and Brokers* (2nd ed, 1989) p 23.

52 *Rest-Ezi Furniture Pty Ltd v Ace Shohin (Australia) Pty Ltd* (1987) ATPR 80-081.

53 Note 41 *supra*.

54 Note 42 *supra*, per Barwick CJ at 321.

III. BROKERS' DUTIES IN EQUITY

A. THE SCOPE OF A BROKER'S FIDUCIARY DUTIES

At general law, a broker which is instructed to buy and sell shares acts as agent for its client. In *Christopher Barker & Sons v IRC*,[55] Rowlatt J observed that a broker "is a buyer and seller in the market for an undisclosed principal to whom he looks to indemnify him for liability...The stockbroker is remunerated by a commission which he receives from his principal, the person who takes the liability off his shoulders." It may be that closer analysis requires a distinction to be drawn between the role of agents generally and the role of the securities broker. The securities broker typically trades in a competitive market, where the price of the commodity is set by a large number of individual trades and where the broker has limited ability to influence that price by negotiation with the other party to the transaction. The significance of this factor was recognised in the judgment of Jacobs JA in *Jones v Canavan*,[56] where His Honour observed that:

> The limited function of the stock and sharebroker makes him an intermediary rather than a negotiating agent. He has the privilege of operating upon a very special kind of market where the commodity is in more or less large supply and the trends are governed by a conjunction of factors depending upon the actual buying and selling orders held by brokers. Although no doubt each broker on each order has an obligation to obtain the best price he can, the lowest for the buyer and the highest for the seller, he accomplishes this by nothing which could be described as a negotiation in the ordinary sense of an agent negotiating a sale or a purchase.[57]

Prima facie, the fact that a broker acts as agent for its client gives rise to a fiduciary relationship between the broker and its client. The leading Australian decision as to the scope of the broker's fiduciary obligations to its client is *Daly v Sydney Stock Exchange Ltd.*[58] The appellant had placed money with a broking firm as a loan, after an employee of the firm advised her not to invest immediately in the stock market. The High Court had to consider s 58(1)(b) of the *Securities Industry Act* 1970 (NSW) and s 97(1)(b) of the *Securities Industry Act* 1975 (NSW), which restricted the availability of compensation from the fidelity fund of The Sydney Stock Exchange to persons who had suffered pecuniary loss occurred in connection with money entrusted to or received by a partner or employee of a broking firm for and on behalf of another person, or by reason that the firm or a partner in the firm was a trustee of the money, where the loss resulted from a 'defalcation' committed by partners or employees of the firm. The Court held that the relationship of the appellant and the firm was that of debtor and creditor, and that no constructive trust arose in

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55 [1919] 2 KB 222 at 229.

56 Note 18 *supra*.

57 *Ibid* at 245.

58 (1985) 160 CLR 371.

relation to the money deposited with the firm. Since the firm's failure to repay the loan was not a defalcation under the relevant statute, the appellant was unable to recover her loss from the fidelity fund.

The Court held that, in a relationship of a fiduciary quality, an adviser could not place itself in a position where there was a real and serious possibility of a conflict between its interests and its duty to its client, including the specific duty to give honest and impartial advice. Gibbs CJ (with whom Wilson and Dawson JJ agreed) observed that "[n]ormally, the relation between the stockbroker and his client will be of a fiduciary nature and such as to place on the broker an obligation to make to the client a full and accurate disclosure of the broker's own interest in the transaction."[59] That approach suggests that the fact of a broker-client relationship is sufficient to give rise to fiduciary obligations owed by a broker to its client. Brennan J placed greater emphasis on the incidents of the dealings between the broker and its client, holding that a broker which holds itself out as having expertise in advising as to investments and which undertakes to give advice stands in a fiduciary relationship to the person whom it advises.[60] Brennan J noted that, as a fiduciary, a broker was under a particularly demanding duty if it proposed to offer the client an investment in which it has a financial interest. In that situation, the broker was required to furnish the client with all relevant knowledge possessed by the broker, concealing nothing that might reasonably be regarded as relevant to the making of an investment decision; to reveal the identity of the buyer or seller of the investment when that identity is relevant; to give the best advice which the broker could give if it did not have a financial interest in the investment offered to the client; to reveal fully the broker's financial interest; and to "obtain for the client the best terms which the client would obtain from a third party if the adviser were to exercise due diligence on behalf of his client in such a transaction".[61]

Notwithstanding the difference between the traditional function of an agent and that of a securities broker identified by Jacobs JA in *Jones v Canavan*,[62] the relationship between broker and client is characterised by features which typically support the imposition of fiduciary duties. The entrusting to the fiduciary of the "power to affect those interests in a legal or practical sense" and the fiduciary's undertaking "to act in a particular matter in the interest of another" are typical of the fiduciary relationship.[63] In *Hospital Products Ltd v United States Surgical Corporation*,[64] Mason J observed that:

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59 *Ibid* at 377.

60 *Ibid* at 385.

61 *Id.*

62 Note 18 *supra.*

63 LS Sealy, "Some Principles of Fiduciary Obligations" [1963] *Camb LJ* 119 at 122; PD Finn, *The Law of Fiduciaries* (1977) p 201; *Hospital Products Ltd v United States Surgical*

> The critical feature of these relationships is that the fiduciary undertakes or agrees to act for or on behalf of or in the interest of another person in the exercise of a power or discretion which will affect the interest of that other person in a legal or practical sense. The relationship between the parties is therefore one which gives the fiduciary a special opportunity to exercise the power or discretion to the detriment of that other person who is accordingly vulnerable to abuse by the fiduciary of his position.[65]

A broker has the power to affect the interests of its client and has, by the nature of the agency relationship with its client, undertaken to act in the interests of the client. The broker has a greater opportunity to take advantage of its client than would be the case in an arm's length relationship, the vulnerability of the client arising in large part from the existence of the broker-client relationship.[66] The imposition of fiduciary obligations on the broker has a 'prophylactic' operation characteristic of the fiduciary relationship, preventing the broker from taking advantage of its client and operating in support of a relatively high standard of proper conduct as between the broker and its client.[67] Admittedly, the dealings between a broker and its client may in some circumstances have the features of an arm's length dealing between parties of equal bargaining power: for example, a transaction undertaken by a bank-backed broker on the instructions of an institutional client. However, since agency is a traditional category of fiduciary relationship, the High Court's reluctance to import fiduciary duties in an arm's length setting should not extend to denying a fiduciary quality to the broker-client relationship.[68]

There is a strong argument that the imposition of fiduciary obligations in dealings between brokers and their clients is economically efficient. If dealings between brokers and their clients were not characterised as fiduciary in nature, a well-informed client would either closely supervise the conduct of the broker or seek a contractual subordination of the broker's trading interests to that of the client. The characterisation of the broker-client relationship as fiduciary makes

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Corporation [1982] 2 NSWLR 766 at 207-208 (Court of Appeal), (1984) 156 CLR 41 (High Court) per Gibbs CJ at 71-72.

64 Hospital Products, *id.*

65 *Ibid* per Mason J at 96-97.

66 For the significance of the beneficiary's vulnerability in supporting the imposition of fiduciary obligations, EJ Weinrib, "The Fiduciary Obligation" (1975) 25 *University of Toronto LJ* 1 at 5; JC Shepherd, "Towards a Unified Concept of Fiduciary Relationships" (1981) 97 LQR 51 at 69.

67 *Bray v Ford* [1896] AC 44 per Lord Herschell at 51-52; EJ Weinrib, *ibid* at 3,6; AJ Black "Dworkin's Jurisprudence and *Hospital Products*: Principles, Policies and Fiduciary Duties" (1987) 10 *UNSWLJ* 8 at 19; PD Finn, "Good Faith and Nondisclosure" in PD Finn (ed), *Essays on Torts* (1989) p 165.

68 JRF Lehane, "Fiduciaries in a Commercial Context" in PD Finn (ed), *Essays in Equity* (1985) pp 97-99; J Gill, "A Man Cannot Serve Two Masters: The Nature, Existence and Scope of Fiduciary Duties" (1989) 2 JCL 115 at 116.

it unnecessary for individual brokers and their clients to negotiate contractual terms defining the obligations of the broker in the event of a competition between the broker's personal interests and the interests of the client and providing for the consequences of breach of the broker's obligations. It follows that the characterisation of the broker-client relationship as fiduciary in nature reduces the transaction costs of contracting between brokers and their clients.[69]

It is well established in Australian law that the scope of a fiduciary duty may be limited to coincide with any limits to the scope of the fiduciary's undertaking. Specifically, the scope of the fiduciary duty may be restricted so as to reflect the contractual basis of the dealings between a fiduciary and the person to whom the duty is owed.[70] In determining the scope of the fiduciary duty owed by a broker to its client, it is therefore necessary to take into account the nature of the obligations accepted by the broker in dealing with that client. There may be considerable variation from case to case in the incidents of the broker-client relationship, depending on the extent of the dependence of the client on the broker for information about investment strategies and the performance of the market; the extent to which the client acts on the broker's recommendations; the number of dealings between the broker and the particular client; and the scope of the broker's retainer. That retainer may be limited to executing trades in accordance with the broker's instructions, or may extend to offering advice as to trading decisions, or to operating a discretionary account on behalf of the client. The scope of a broker's fiduciary obligations would typically be narrowed if the broker merely executes transactions on the client's instructions and the client does not rely upon the broker for advice. In such a case, it may be that the broker's duty should extend no further than to define the manner in which the trade is to be executed. The American authorities[71] suggest that the scope of a broker's fiduciary duty to its client will be narrowed where the broker's role is merely to undertake a purchase or sale of securities on market,[72] or where a broker executes transactions for the account of a sophisticated investor which does not seek the broker's advice or allow the broker to make trading decisions on its behalf.[73] By contrast, the scope of the

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69 V Brudney & RC Clark, "A New Look at Corporate Opportunities" (1981) 94 *Harv LR* 997 at 999; DC Langevoort, "Fraud and Deception by Securities Professionals" (1983) 61 *Texas Law Review* 1247 at 1249-1250; AJ Black, note 67 *supra* at 27.

70 *New Zealand Netherlands Society Oranje v Keys* [1973] 1 WLR 1126 per Lord Wilberforce at 1130; *Hospital Products*, note 63 *supra* per Gibbs CJ at 73, per Mason J at 99, per Deane J at 123.

71 For discussion of the characterisation of the broker-client duty as fiduciary under American law, see JD Cox, RW Hillman & DC Langevoort, *Securities Regulation: Cases and Materials* (1991) p 1210; CR Goforth, "Stockbrokers' Duties to their Customers" (1989) 33 St Louis University LJ 407 at 419.

72 *Robinson v Merrill Lynch, Pierce, Fenner & Smith Inc* 337 F Supp 107 at 111 (1971)

73 *Shearson Hayden Stone Inc v Leach* 383 F 2d 367 (7th Cir 1978).

broker's fiduciary duty would be wider if a client regularly sought investment advice from the broker and typically acted on the broker's recommendations.

As fiduciary, a broker is obliged to avoid situations where there is a real and serious conflict between its interests and the interests of the client within the scope of its duties, or between its interests and its duties to the client.[74] A broker is under a duty as fiduciary neither to compete with the client in trading on its own account, nor to allow itself to be placed in a situation of conflict between its duties to different clients. In *Armstrong v Jackson*,[75] McCardie J observed that, irrespective of whether the broker sells at market price or acts without fraudulent intent, he will not be permitted "to place himself in a situation which, under ordinary circumstances, would tempt a man to do that which is not best for his principal."[76] The broker is under a duty to disclose to a client information which would reveal that a transaction is likely to be disadvantageous to the client, and to make full and accurate disclosure to the client of the broker's interest in a transaction.[77] The *ASX Business Rules* give specific application to the rule against conflict of interest. For example, Rule 3.11 prohibits a broker which is required or will be required to acquire a shortfall of shares as underwriter to a public issue of shares from offering those shares to a client within 90 days of the closing date of the issue unless it first informs the client of the closing date of this issue and the fact of that shortfall. Even in the absence of Rule 3.11, the rule against conflict of interest would have required a broker which had a personal interest in disposing of a shortfall of shares to make such disclosure to its client.

A broker may avoid the consequences of breach of fiduciary duty by obtaining its client's ratification of the breach after full disclosure of the breach, either in anticipation or after the event.[78] However, the observations of Brennan J in *Daly v Sydney Stock Exchange*,[79] noted above, suggest that a broker remains under a duty to give its client the best advice which it could have given if it had no interest in the transaction, even after it has disclosed that interest to its client. As a practical matter, a broker which has an interest in a transaction may find it difficult to satisfy (or to demonstrate that it has satisfied) this additional requirement, since there is a risk that its interest in the

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74 *Chan v Zacharia* (1984) 154 CLR 178 per Deane J at 199.

75 [1917] 2 KB 822.

76 *Ibid* 824. See also *Hewson v Sydney Stock Exchange* (1968) 2 NSWR 224; *Bonds & Securities (Trading) Pty Ltd v Glomex Mines NL*, note 28 *supra*; *Daly v Sydney Stock Exchange Ltd*, note 58 *supra*.

77 *Daly v Sydney Stock Exchange Limited*, note 58 *supra*.

78 In *NZ Netherlands Society v Keys* [1973] 2 All ER 1222 at 1227, Lord Wilberforce observed that "if an arrangement is to stand, whereby a particular transaction, which would otherwise come within a person's fiduciary duty, is to be excepted from it, there must be full and frank disclosure of all material facts"; PD Finn, *Fiduciary Obligations* (1977) pp 227-228.

79 Note 58 *supra* at 385.

transaction could have a residual or unconscious influence on its advice even after that interest has been disclosed to the client. One commentator has argued that this additional requirement is unjustified in principle, suggesting that:

> [p]rovided the fiduciary discloses the nature and extent of the conflict, and apprises the beneficiary of the possible difficulties that may arise in advising as a result thereof, if the beneficiary chooses to continue with the fiduciary as his adviser, the fiduciary's liability in and for that advice should be measured by the common law standard appropriate to his calling.[80]

B. EQUITABLE REMEDIES

Breach of fiduciary duty may render voidable a contract between a broker and its client. Breach of fiduciary duty may also disentitle the broker to recover commission on the transaction; or render it liable to account to the client for any profit or to make compensation in equity for any loss suffered by the client.[81] The characterisation of the broker-client relationship as fiduciary has a further consequence. By extension of *Nocton v Lord Ashburton*,[82] it is arguable that a broker which offers advice to its client is under a duty in equity to take care that it has a reasonable basis for the advice which is given. A breach of this duty allows the client to seek equitable compensation for loss suffered in reliance on advice offered by a broker without a reasonable basis. Although the matter is not determined by authority, it may be that the equitable duty to take care in offering advice is more demanding than the duty of care imposed under the law of negligence. The countervailing consideration is the obvious inconvenience of recognising a standard of care in equity, imposed on brokers, which differs from the duty of care imposed on other professionals (for example, accountants) in tort.

The measure of equitable compensation awarded to a client will not necessarily coincide with the measure of damages in tort. There is authority that equitable compensation is recoverable for loss which would not have been suffered by a beneficiary in the absence of breach of duty by the fiduciary, and that the amount of compensation is governed by equitable considerations, such as fairness as between the fiduciary and its beneficiary.[83] Equitable compensation is not subject to the requirements of foreseeability and remoteness of damages which apply in tort. It appears that the defence of

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80 PD Finn, note 67 *supra* at p 169.

81 *Nocton v Lord Ashburton* [1914] AC 932; IE Davidson, "The Equitable Remedy of Compensation" (1982) 13 *MULR* 349; JB Kearney, "Accounting for a fiduciary's gains in a commercial context" in PD Finn (ed) *Equity and Commercial Relationships* (1987) pp 182-216.

82 *Id.*

83 *Re Dawson* [1966] 2 NSWR 211, *Mead v Day* [1987] 2 NZLR 443 per Somers J at 461-462, per Casey J at 468; WMC Gummow, "Compensation for Breach of Fiduciary Duty" in TG Youdan (ed), *Equity, Fiduciaries and Trusts* (1989) p 82.

contributory negligence which is available to reduce the quantum of damages in an action for negligence is not available to a defendant in an action for equitable compensation. However, the beneficiary's responsibility for the loss which he or she has suffered could properly be taken into account in determining the amount of the beneficiary's loss which is fairly attributable to the fiduciary's breach of duty.[84]

The existence of a fiduciary relationship between broker and client will, in appropriate circumstances, allow the client to trace scrip or money on the insolvency of the broker, even if the broker has mixed the client's funds with the broker's funds in contravention of its obligations under Chapter 7 of the *Corporations Law*. In *Re Ararimu Holdings Ltd*,[85] a broker had mixed monies from its general account with monies paid in by clients and monies received on the sale of clients' shares, paying all of those monies into a single bank account. The broker had also pooled scrip purchased for different clients. The New Zealand High Court held that the fiduciary character of the broker-client relationship could provide the basis for a client to trace scrip or monies held by the broker on the client's behalf if the broker became insolvent. The Court held that the rule in *Clayton's Case*[86] (moneys should be treated as paid out of a running account in the order in which they had been paid in) was prima facie applicable to money in the broker's bank account. However, claimants should be allowed to share funds in proportion to their contribution to the account in circumstances where the facts did not allow the rule in *Clayton's Case* to be applied. On the facts of the case, the Court found that the order of entries on the broker's bank statement was arbitrary and there was no other evidence of the order of payment into or out of the account. Accordingly, moneys in the account should be shared between clients in proportion to their contributions to the account. The Court further held that a client would be entitled to trace into the pool of scrip if he or she could identify a proprietary interest in a payment which had purchased particular shares in the pool, and that the client would have an equitable interest in the scrip once a completed allocation had been made out of the pool.

C. BROKER'S DUTY OF CONFIDENTIALITY

There is some basis for the conclusion that a broker owes a duty of confidentiality to its client, although securities texts generally do not recognise such a duty.[87] The American courts have held that such a duty exists, and that

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84 *Mead v Day*, *ibid* per Casey J at 468.

85 [1989] 3 NZLR 487.

86 (1816) 1 Mer 572, 35 ER 781.

87 G Cooper and RJ Cridlan, note 12 *supra* and R Baxt et al, note 5 *supra*, do not refer to such a duty. However, DJ Williams, *Investigations by Administrative Agencies* (1987) p 28 includes stockbrokers in the category of persons who owe a duty of confidence to their

it requires that a broker neither release information imparted by the client to another nor utilise that information for the broker's personal advantage.[88]

There is a strong argument that information held by a broker as to the identity of its client and the order placed by the client has the necessary quality of confidentiality to attract an obligation of confidence.[89] It is clear that the name of a person's client may itself be confidential information.[90] The information retains a degree of secrecy, since in the ordinary case the only persons aware that an order has been placed will be the broker and its client. Both a broker and a client would expect that the broker was not free to reveal the fact that an order had been placed by a client or to reveal details of that order to third parties. The existence of a duty of confidence owed by brokers to their clients may also be supported on the basis that this is a consequence of the broker's professional relationship with its client.[91] Adherence to this obligation is necessary to allow a client to obtain the best bargain in respect of shares, which he or she may not obtain if the fact that he or she had placed the order became known to other purchasers who were led to place competing orders. Similarly, respect for the obligation of confidentiality is necessary to allow a client to accumulate a parcel of shares in a company without disclosing his or her identity, subject to statutory obligations of disclosure.

Rule 3.15 of the *ASX Business Rules* impacts upon the broker's duty of confidentiality. That Rule authorises brokers to report information relating to the terms, circumstances of and parties to any dealings in securities by clients to the ASX Surveillance Department. Subject to Rule 3.15(3), the officers and employees of that department are in turn authorised to disclose that information, inter alia, to any governmental agency or public or regulatory body which, in the proper exercise of its powers, requests the Exchange to provide the information; to any person to whom the Board delegates its authority to adjudicate on matters of discipline; and "to any person to whom, in the opinion of an Authorised Person, disclosure should be made in the interests of promoting the order and good government of the Member or Member Organisations of the Exchange and the maintenance and promotion of an

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clients. That conclusion is also expressed by the writer in *Australian Corporation Law* para [7.1.0520].

88 *McMann v SEC* 87 F 2d 377 (2d Cir 1937); CR Goforth, note 71 *supra* at 439

89 *Seagar v Copydex* (No 1) [1967] 2 All ER 415 per Lord Denning MR at 417; *Coco v A N Clark (Engineers) Ltd* [1969] RPC 41 per Megarry J at 47; PD Finn, "Confidentiality and the Public Interest" (1984) 58 *ALJ* 497 at 501.

90 *Hunter v Mann* [1974] QB 767.

91 Duties of confidence are frequently an incident of the existence of a professional relationship: F Gurry, *Breach of Confidence* (1984) pp 157-158; *Parry-Jones v Law Society* [1969] 1 Ch 1 per Lord Denning MR at 7; *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461 per Scrutton L J at 380, per Bankes L J at 471-472, per Atkin L J at 483-484.

efficient, informed and properly regulated market." In the absence of Rule 3.15, there would be a real possibility that a broker which supplied information to ASX as to trading by the broker's client would breach a duty of confidence owed to that client. It is clear that a request by ASX for a broker to disclose the identity of its client or the nature of a transaction is not made under compulsion of law, in the absence of powers comparable to the powers of the Australian Securities Commission ('ASC') under the *Corporations Law*. The defence of public interest would not necessarily be available to a broker which revealed information which was confidential to its client to ASX, since that defence is limited to specific categories of crime or inequity or matters which are dangerous or detrimental to the public or amount to a fraud on the public. Although an obligation of confidence will not extend to a crime or civil wrong,[92] it is likely that at least some of the transactions which are the subject of investigation by ASX do not involve any breach of law.

The question then arises whether a broker which reveals information to ASX in response to a request made by the Surveillance Department under Rule 3.15 can rely on that Rule as a defence to an action by the client for breach of confidence. The terms of the contract note which a broker is required to issue to its client under Rule 3.8(2) provide that the contract between the client and the broker is formed subject to the Articles of Association, Rules and Regulations, by-laws, customs and usages of the Exchange. The terms of Rule 3.15(2), authorising disclosure of information relating to dealings in securities to the Exchange Surveillance Department, are accordingly incorporated in the broker's contract with its client. That provision would seem to be sufficient to provide a contractual defence to an action in breach of confidence by the client if a broker reported information to ASX in compliance with Rule 3.15(2).

IV FINANCIAL CONDITIONS AND ACCOUNTING REQUIREMENTS IMPOSED ON SECURITIES BROKERS

A. FINANCIAL CONDITIONS IMPOSED ON HOLDERS OF DEALERS LICENSES

Financial conditions imposed upon dealers licences under the Corporations Law and liquidity requirements imposed upon brokers under the *ASX Business Rules* are intended to secure the ability of dealers to meet their financial commitments, and may be justified by reference to the financial risks involved in dealing in securities. The NCSC Discussion Paper *A Review of the Licensing Provisions of the Securities Industry Act and Codes* (1985) noted that securities dealers are faced with credit risks arising from the possibility of default by a client where the dealer has acquired securities for the client from another dealer;

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92 *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461; *Allied Mill Industries Pty Ltd v Trade Practices Commission* (1981) 34 ALR 105.

from market risk where the dealer itself trades in the market as principal; and from underwriting risk if the dealer may be required to commit funds to a float because of a shortfall in the issue. If a dealer fails, there is a risk that moneys or securities entrusted to the dealer by clients will not be applied for the purpose intended by the client and that monies or securities held by the dealer on a client's account may be lost. Financial conditions imposed upon licensed dealers are intended to reduce those risks.[93]

Section 786(1) of the *Corporations Law* permits dealers licences to be issued subject to prescribed conditions and subject to conditions and restrictions imposed by the ASC when granting the licence or at any time the licence is in force. Section 786(2) indicates the type of conditions and restriction which may be prescribed. Sections 786(2)(a) and 786(2)(b) authorise the ASC to impose conditions and restrictions limiting the liabilities that the holder of a dealers licence may incur in connection with a business of dealing in securities; conditions and restrictions as to the dealers incurring liabilities other than in connection with his business of dealing in securities; and requirements of disclosure as to such liabilities. Section 786(2)(c) authorises the ASC to impose conditions and restrictions as to the financial position of the holder of a dealers licence. Conditions imposed under s 786(2)(c) need not be limited to the dealer's financial position in relation to its business of dealing in securities. For example, the ASC could properly impose liquidity requirements upon a dealers licence issued to a broker which proposed to conduct its business as trustee of a trading trust.[94] Regulation 7.3.01 of the *Corporations Regulations* requires the holder of a licence to give written notice to the ASC of any event which may adversely affect the financial position of the licensee, not later than the day after the day on which the license holder becomes aware of that event.

B. LIQUIDITY REQUIREMENTS UNDER THE ASX BUSINESS RULES

Since brokers have no choice as to the other brokers with whom they will deal, the failure of one stockbroker is capable of causing financial difficulties for other brokers with whom the failed broker had opened credit transactions.[95] Rule 1.1 of the Business Rules establishes capital liquidity requirements for members of ASX, which reflect the fact that unduly thin capitalisation of Exchange members would increase the risk of insolvency. The existence of minimum capital requirements increases the likelihood that a broker acting on the other side of a transaction will be able to meet its obligations. In effect, Rule 1.1(2) requires that a broker maintain a prescribed relationship between its

93 Note 2 *supra*, para [5.19].

94 *RWG Management Ltd v Corporate Affairs Commission* (Vic) [1985] VR 385, (1984) 9 ACLR 739.

95 Note 2 *supra*, paras [8.2], [8.3].

Adjusted Liquid Capital and its Aggregate Indebtedness.[96] Broadly speaking, a broking firm which is a partnership is required to ensure that the Adjusted Liquid Capital in its business is at all times not less than the greater of $50,000 or 5% of the its Aggregate Indebtedness, while a broker which is incorporated must ensure that the Adjusted Liquid Capital in its business is at all times not less than the greater of $250,000 or 5% of its Aggregate Indebtedness. Rule 1.1(4) of the Business Rules requires a broker to notify the Exchange if its Adjusted Liquid Capital, as defined, is at any time less than the minimum amount required by Rule 1.1.

The minimum capital requirements are reinforced by certain requirements under the Business Rules as to the conduct of a broker's business, which limit the application of the broker's capital. For example, Rule 2.7 of the *ASX Business Rules* provides that a broker shall not on its own account or on the account of a partner of the broker or a director of a member corporation which constitutes the broker, or on any account in which they are directly or indirectly interested, effect purchases or sales which are excessive in relation to the financial resources of that person. That Rule is intended to prevent transactions by the broker or its associates in excess of their financial resources, which could ultimately impact on the liquidity of the broker.

C. ACCOUNTING OBLIGATIONS

Certain obligations of securities brokers in relation to accounting and auditing are imposed as statutory requirements under the *Corporations Law*. Section 856 requires a securities broker to keep accounting records that correctly record and explain the transactions undertaken in the securities business carried on by the broker and the financial position of that business, and that enable true and fair profit and loss accounts to be made up and conveniently audited. Specified matters must be recorded in those records, which must be kept in sufficient detail to show separately all transactions with or for the account of the broker's clients; with or for the account of the broker or his or her partners; with or for the account of other dealers; and with or for the account of employees of the dealer. Section 860 requires a broker to prepare annual profit and loss accounts and a balance sheet containing prescribed information and lodge those documents, together with an auditor's report containing prescribed information, with the Commission.

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96 The term 'Adjusted Liquid Capital' takes into account the broker's Current Assets (as defined); any unconditional bank guarantee in favour of the Exchange not secured by assets of the broker; assets which are capable of realisation within thirty days, if the capacity to realise those assets has been demonstrated to the satisfaction of the Exchange Examining Accountant. The term 'Aggregate Indebtedness' includes liabilities of the broker other than Approved Liabilities, as defined, but including securities which are the subject of a short sale by a broker as principal; and excludes amounts due to or received from clients and held in trust by the broker in compliance with Rule 1.2.2.

Section 864 preserves the ability of a securities exchange to impose upon its members additional obligations as to the keeping of books, the auditing of accounts and the provision of information in auditor's reports, provided that such obligations are not inconsistent with Chapter 7 of the *Corporations Law* or with a condition of the dealers licence held by the broker. The *ASX Business Rules* impose additional obligations in expansion of stockbrokers' accounting and auditing obligations under the *Corporations Law*. For example, Rule 1.3 of the *ASX Business Rules* provides for the preparation of annual accounts by brokers, to be furnished to the Exchange Examining Accountant not later than two months after the end of the broker's financial year, and for the appointment of auditors and the auditing of broker's accounts, including the audit of the broker's scrip records to the extent designated by the Exchange. Rule 1.5 of the Business Rules requires a broker to furnish a schedule of investments at the end of its financial year, to prepare a schedule showing amounts held in its trust account on behalf of clients as at specified dates and furnish a copy of that schedule to its auditor.

V. CONDUCT OF BUSINESS REQUIREMENTS UNDER PART 7.3 OF THE CORPORATIONS LAW AND THE ASX BUSINESS RULES

Part 7.3 of the *Corporations Law* imposes financial requirements and requirements as to conduct of business upon securities brokers, by virtue of their status as licensed dealers. Conduct of business obligations, whether imposed as statutory obligations or as licence conditions, may be enforced in proceedings brought by the ASC under s 1114 of the *Corporations Law*, which authorises the court to make certain orders on the application of the ASC if a person has contravened the conditions or restrictions of a licence. In the case of persistent or continuing contraventions of Chapter 7 of the *Corporations Law*, any other law relating to trading or dealing in securities, the conditions or restrictions of a licence, or the business rules of a securities exchange, the orders which may be made by the court under s 1114 include an order restraining a person from carrying on a business or doing an act or classes of acts in relation to securities.

Section 3 of the *ASX Business Rules* also imposes obligations upon brokers in their dealings with clients, including obligations of disclosure if the broker trades as a principal (Rule 3.1) and of disclosure of allocation policy (Rule 3.3); obligations as to settlement with clients (Rule 3.6); and obligations as to the issue of contract notes (Rule 3.8). Section 3 of the Business Rules overlaps with the broker's fiduciary obligations to its client, and with statutory duties of brokers arising under ss 849 and 851 of the *Corporations Law*. Section 3 of the Business Rules reflects fundamental policy objectives underlying the regulation of securities trading intermediaries, seeking to reduce the risk that a broker

which has an element of discretion in its dealings with its client might prefer its own trading interests to that of its client; might advise the client to undertake an excessive number of transactions in order to increase its receipts from commission; or might misappropriate funds or securities held on behalf of its client.[97]

In July 1991, ASX released a Discussion Paper entitled ASX *Principles; Code of Conduct* ('Discussion Paper'), which proposed the introduction of a set of 'Principles' and a 'Code of Conduct' which would, in conjunction with the *ASX Business Rules*, govern the conduct of members of ASX. The Discussion Paper suggested that the proposed Principles were intended to assist in the interpretation of the *ASX Business Rules*; that they would set "a standard against which a Broker's adherence to the [Business] Rules and industry standards may be judged"; that they "may be capable of being the subject of disciplinary action in their own right"; and that they would establish "a basis upon which conduct could be judged to be not efficient, honest, fair or be otherwise prejudicial to the Exchange or its members". The Discussion Paper also indicated that a broker could, in appropriate circumstances, be charged with a breach of the proposed Code of Conduct. Proposed Principle 1 would require brokers to "observe high standards of honesty, integrity and fairness". Proposed Principle 2 would require brokers to "act with due skill, care, diligence and efficiency". Together, these principles cover substantially the same ground as Article 52 of the *ASX Articles of Association* (discussed below), which empowers the ASX Board in appropriate circumstances to charge a member with prohibited conduct, being conduct which is not efficient, honest or fair or is otherwise prejudicial to the interest of the Exchange or its members.

Proposed Principle 3 would require brokers to "observe high standards of market conduct". Proposed Principle 4 deals with "client relations" and would require brokers to "at all times place the interest of their clients above their own". That principle overlaps with brokers' fiduciary obligations to their clients. Proposed Principle 5 overlaps with Proposed Principle 4, and provides that members and member organisations "shall take all reasonable measures to minimise conflicts of interests arising and should conflicts arise they shall take all reasonable steps to ensure the client's interests are held paramount". Proposed Principle 6 deals with the treatment of client's assets, and would require brokers to "arrange proper protection for assets of their clients received or entrusted to them". Proposed Principle 7 would require brokers to "maintain adequate financial resources and liquidity to meet their commitments as and when they fall due". Proposed Principle 8 would require member organisations to "maintain adequate internal controls and records to satisfy their obligations as a Member Organisation". Section 4 of the proposed ASX Code of Conduct

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97 MQ Connelly, "The Licensing of Securities Market Actors", in: *Proposals for a Securities Market Law for Canada* (1978) pp 1273-1274; *Australian Corporations Law* (1991) para [7.1.0780].

would impose a number of specific obligations as to dealings with clients. A broker would be required to communicate any circumstance which limited its independence to its client (para 1); to "take all reasonable steps to find and deal in the market at the price which is the best available for the client" (para 2); to advise the client of any benefit to the broker or its employees arising from a transaction, whether financial or otherwise, other than a commission charged to the client (para 3); and to take "reasonable steps to provide its client with all information necessary to enable the client to exercise effective judgement in relation to investment decisions" (para 9).

One commentator has suggested that the regulation of the securities industry will not necessarily be well served by imposing generalised 'Principles' and a 'Code of Conduct' in addition to the specific requirements of the Business Rules. It is arguable that the standards expressed in the proposed Principles and Code of Conduct are not sufficiently precise to allow brokers to know whether conduct would comply with their requirements in particular circumstances. If the content of the Principles and the Code of Conduct and their interaction with the *ASX Business Rules* is not precisely defined, it will be difficult for ASX to exercise its powers consistently and predictably, and almost impossible for a broker to challenge a decision of ASX as involving an incorrect exercise of those powers. It is also open to question whether it is desirable, as a matter of policy, for a Code of Conduct adopted by a self-regulatory body to impose requirements on brokers which overlap with requirements which already have specific expression under the *Corporations Law*. At best, it might be suggested that such a restatement of existing statutory obligations involves unnecessary duplication. At worst, the proposed Principles and Code of Conduct involve a risk that brokers would be subject to enforcement proceedings brought by a self-regulatory body based on relatively imprecise guidelines, notwithstanding compliance with their obligations imposed in equity and under the *Corporations Law* in respect of the same class of conduct.[98]

A. OBLIGATIONS AS TO THE TREATMENT OF CLIENTS' PROPERTY

From time to time, brokers hold assets on behalf of their clients, such as scrip, securities held in the nominee company of a broker, securities held in sponsored accounts, and money held for a client, whether or not in connection with a market transaction. Chapter 7 of the *Corporations Law* deals with treatment of moneys and scrip received by the holder of a dealers licence on account of or by loan from clients. Sections 866-871 require holders of dealers licences to maintain trust accounts, specifying moneys which are required to be paid into the trust account, withdrawals which may be made from the trust account, and excluding moneys in the trust account from moneys available to satisfy the dealer's debts. Section 872 regulates the application of moneys lent

98 AJ Black, "ASX Principles and Code of Conduct: ASX Discussion Paper, June 1991", [1991] *Butterworths Corporation Law Bulletin*, para [341].

to the dealer in connection with the securities business carried on by the dealer. The dealer may not use those funds other than for purposes set out in a written statement given to the person who lent the funds. The requirements as to the maintenance of trust accounts imposed upon licensed dealers under Chapter 7 of the *Corporations Law* overlap with obligations imposed on brokers under the *ASX Business Rules*. Rule 1.2.2 of the *ASX Business Rules* requires a broker to establish a trust account and to pay certain moneys into the trust account, while rule 1.2.2(4) details circumstances in which moneys may be paid out of that account. The existence of trust account requirements, which cannot be excluded by the receipt of contrary instructions from a client, is supportable on policy grounds. In the absence of such requirements, or if a broker and its client could agree to waive those requirements, the client would be exposed to the risk that the client's assets would be mixed with those of the broker and to the consequent risk of loss if the broker became insolvent.

Section 889 of the *Corporations Law* requires members of the stock exchange to lodge and maintain statutory deposits with the exchange. That deposit is payable out of money held in the broker's trust account maintained under s 866 of the *Corporations Law*, and is required to equal two-thirds, or a prescribed lesser proportion, of the lowest aggregate balance in the broker's trust accounts during the previous quarter: s 890(1). The ASC is authorised to seek specified orders in relation to a dealer's bank accounts if there are reasonable grounds for believing that there is a deficiency in the dealer's trust account; the dealer has failed to comply with or has unduly delayed in complying with its obligations to pay moneys into a trust account or other account; or has otherwise improperly applied or accounted for trust moneys.[99] In certain circumstances, contravention of the trust account requirements imposed upon a dealer under Chapter 7 may give rise to a constructive trust over the moneys involved in the contravention, allowing a client to trace those moneys if the dealer becomes insolvent.

At common law, a broker was not entitled to sell or pledge securities held on behalf of a client without the authority of its client. In *Solloway v McLaughlin*,[100] the Privy Council held that a broker had no right to deal with shares which had been deposited with the broker on margin calls, and that the broker's sale of the shares amounted to the tort of conversion. The broker's client was awarded damages for conversion, measured as the value of the shares at the date of the conversion less the value of any shares which were subsequently delivered to the client in substitution for the converted shares as at the date the client received them.[101] In *Tobin v Broadbent*,[102] a broker pledged share certificates, which were the property of its client and were registered in

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99 *Australian Corporation Law*, para [7.2.0140].

100 [1938] AC 247.

101 *Ibid* per Lord Atkin at 256.

102 (1947) 75 CLR 378

the name of its client, as security for an advance made to the broker. Latham CJ held that there was no practice of brokers in Australia which conferred any authority on a broker to pledge the shares and that the client was not estopped from relying on the actual limits to the broker's authority. His Honour disapproved earlier English authority that a person who placed share certificates endorsed with a signed transfer in the hands of a broker was estopped from setting up title against persons with whom the broker had pledged certificates if the pledgee had taken them bona fide.[103] Dixon J (with whom McTiernan J agreed), held that, in the absence of evidence to the contrary, there was no ground for holding that it was within the recognised scope of a broker's business to raise money in its own name by mortgaging or pledging its client's interests in securities which it held on behalf of its client. In reaching that conclusion, Dixon J noted that different considerations might apply under the then practice of the London stock market, by which a broker in a continuation of a bargain or 'contango' held shares as its own and might deal with those shares as it chose.[104]

The position at common law is altered by s 873 of the *Corporations Law*. Section 873(4) requires a broker to cause securities to be registered in its client's name, if those securities are to be held in safe custody for its client. Section 873(5) permits a broker to use securities held on behalf of a client as security for a loan or advance in limited circumstances, namely where the client is indebted to the broker in connection with a transaction undertaken by the broker on the client's behalf; the broker gives written notice to the client of its intention to use the specified certificates as security; and the amount which the broker borrows on the security of the securities is not greater than the amount of the client's indebtedness to the broker.[105]

B. CROSSING TRANSACTIONS

The term 'crossing' is defined in the *ASX Business Rules* as a transaction in securities where a broker acts on behalf of both buying and selling clients, or where the broker acts as principal on one side of the transaction, and where the transaction is effected in accordance with Rule 2.6(13), Rule 2.6(14), Rule 2.6(15) or Rule 2.6(16). A broker's ability to cross an order to buy and an order to sell securities at a particular price is an exception to the principle that an agent may not act for both parties to a transaction without their informed consent. The exception originates in the role of the broker as a market intermediary.[106] The approach to crossings under Australian law should be contrasted with the position under American law, where rule 10b-10 made under the *Securities Exchange Act* 1934 (US) requires a broker to disclose to its

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103 *Ibid* at 393-394.

104 *Ibid* at 407.

105 *Australian Corporation Law*, para [7.2.0115]

106 *Jones v Canavan*, note 17 *supra*.

client in the event of a crossing the fact that the broker is acting as agent to both clients or as agent to a client and as principal on its own account; to disclose the amount of commission due on the transaction; and to disclose that it is acting as market maker if applicable.[107]

The procedure to be adopted in crossings is regulated by the *ASX Business Rules*. The provision in the Business Rules of specific crossing mechanisms reflects the risk that, in the absence of such mechanisms, a large block of shares placed on the market could depress the price of the shares. The crossing mechanisms allow transactions in larger parcels of shares to be negotiated off market and then executed on the market. The effect of the crossing rules is to bring the on-market price at which the trade occurs and the off-market negotiated price together and to allow other traders the opportunity to purchase the shares at prices closer to the market price and the negotiated price.[108] Rule 2.6(12) requires that, prior to crossing shares on SEATS, the broker enter either a bid or offer at the bid price or offer price at which the crossing is intended to take place. The bid entered by the broker is matched with offers in order of priority from the lowest price up to, but not including, offers at the proposed crossing price. The offer entered by the broker is matched with bids in priority from the highest price down to, but not including, bids at the proposed crossing price. The crossing may take place in relation to the number of shares which remain available after this procedure has been completed, but only if the highest bid price and the lowest offer price are not more than one bid apart. The specified procedure is intended to ensure that where bids are made or shares offered for sale by a broker seeking to effect a crossing, all brokers who are buyers or sellers at the time the crossing is effected have access to the shares being crossed, and have the opportunity to sell at prices less than the crossing price and to buy at prices higher than the crossing price.

Rule 2.6(13) deals with 'Special Crossings', defined in the Business Rules as a transaction in securities effected in accordance with the provisions of Rule 2.6(13) rather than on SEATS, for which the price has been mutually agreed between the parties; including, firstly, transactions where the broker acts on behalf of both buying and selling client and, secondly, transactions where the broker acts as principal and the other party to the transaction is a client of the broker. The definition of 'Special Crossing' contemplates that a special crossing is reported to the Exchange as such, and is treated as 'special' within the meaning of that word in s 206BD(2) and s 604 of the *Corporations Law*. Section 206BD(2) provides that an acquisition is not made in the ordinary course of trading on a stock market of a securities exchange if, when reported to the securities exchange, the transaction is described as 'special' under the rules

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107 T Brailsford, "The ASX Crossing Rule: Concepts and Use" (1988) *C&SLJ* 254 at 266; RW Jennings and H Marsh, note 7 *supra*, pp 652-653.

108 T Brailsford, *ibid* at 254; K J Cohen et al, *The Microstructure of Securities Markets* (1986) pp 26-28; *Australian Corporation Law*, para [10.1.0680].

of the securities exchange. Section 604 provides that a reference in s 620 or s 698 to an acquisition of shares in a company at an official meeting of a stock exchange in the ordinary course of trading on the stock market of that stock exchange does not include a reference to an acquisition of shares by a transaction that is described as 'special' under the business rules or listing rules of that stock exchange when it is reported to the exchange.

Rule 2.6(13)(a) permits a broker to effect a Special Crossing where the consideration is not less than $1,000,000, subject to the qualification that a Special Crossing may not take place in equity securities of a company (other than a company incorporated outside Australia) from the time that an announcement is made of a proposed takeover offer or a takeover announcement is first received by the Exchange until the last day on which the offer remains open for acceptance. The prohibition on special crossings also has effect during an on-market buy-back under Part 2.4 Div 4B of the *Corporations Law*. A Special Crossing is also permitted if, in effect, the total value of a group of securities is $2,000,000 or more, and the group of securities contains 10 or more securities each having a value of not less than $100,000: Rule 2.6(13)(c). If that condition is satisfied, securities of different issuers with a value of less than $100,000 may be included in the Special Crossing. This provision permits a special crossing of a portfolio including substantial parcels of securities, although it also includes smaller holdings which could not separately be the subject of a special crossing. If a transaction results from a crossing pursuant to Rule 2.6 of the *ASX Business Rules*, Rule 3.8(4) requires that the broker endorse the contract note issued to its clients with a statement indicating that part or all of the transaction was effected as a crossing.

C. BROKERS' OBLIGATIONS AS TO SHORT SELLING

Short selling of securities occurs where a person sells securities which he or she does not own at the time of the transaction, expecting that the price of the securities on the market will decline and that he or she will be able to purchase the securities short sold at a lower price to allow delivery to the purchaser.[109] A short sale is essentially speculative, since the seller anticipates making a profit on the sale by buying the securities at a lower price so as to allow settlement of the sale.[110] Section 846 of the *Corporations Law* prohibits a person selling securities to a buyer unless either the seller has "a presently exercisable and unconditional right to vest the securities in the buyer" at the time of sale, or believes on reasonable grounds that he or she has such a right, or certain other conditions are satisfied. Section 846(3)(e) permits short sales where the securities are included in a class of securities declared by the board of a securities exchange to be a class of securities to which s 846(3)(e) applies; where the sale is effected as provided by the business rules of the exchange; and

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109 RL Deutsch, "Short Selling" (1983) *C&SLJ* 142 at 142.

110 RR Pennington, *The Law of Investment Markets* (1990) p 12.

at the time of the sale, neither the seller nor any person on behalf of whom the seller sold the securities was associated in relation to the sale with the body corporate that issued or made available the securities. Rule 2.18 of the *ASX Business Rules* establishes the requirements for short sales of approved securities on ASX. A broker is not permitted to short sell an approved security of a corporation or other entity if the result would be that securities amounting to more than 10% of the number of approved securities of that corporation or entity would be subject to short sale contracts. Rule 2.18(7) of the *ASX Business Rules* requires a client who intends to sell short to advise the broker that the sale is short when placing the sell order. This requirement corresponds to s 846(4) of the *Corporations Law*, which requires that a person who requests the holder of a dealers licence to effect a short sale to inform the licence holder that the sale is short at the time the request is made. Rule 2.18(9) sets limits on the price at which short sales may be made, which are intended to prevent short selling accelerating a fall in the market price of a particular security or of the market generally.

The selling broker is required to obtain an initial margin of cover of not less than 20% of the contract price of the securities short sold from its client: Rule 2.18(8)(a). That margin of cover is to be held in trust by the broker until the short sale has been covered by a purchase of the same number of securities from a third party. If the price of the securities short sold rises against the selling client by more than 10% of the contract price at which the securities are short sold, while the selling client remains short, the broker is required to call upon the selling client to provide an additional margin of cover equal to 20% of the amount of increase in the market price of the securities which are short sold: Rule 2.18(8)(b). A broker is also entitled to require its client at any time to pay or to provide security for 100% of the current cost of closing out a short sale at the point at which the demand is made: Rule 2.18(8)(c). If the client fails to provide a margin of cover, the broker is entitled to proceed to close out the short sale at the client's risk and expense. If a loss results, the client is required to account to the broker for the loss, and if a profit results the broker is required to account to its client for the profit.

D. FORWARD DELIVERY TRANSACTIONS

Rule 2.9 of the *ASX Business Rules* sets out brokers' obligations in connection with 'Forward Delivery Transactions', which are contracts which provide for delivery of securities outside the 10 day period specified in Rule 4.33 of the Business Rules. The economic effect of a forward delivery transaction is that the seller of shares allows finance to the buyer of the shares by extending the time available to the buyer to pay for the shares. Rule 2.9 is intended to limit the exposure of a broker to default by either the selling client or the buying client on settlement of the forward delivery transaction. A broker is prohibited from selling or offering to sell securities on a forward delivery basis if those securities are not beneficially owned by the selling client: Rule

2.9(2). Before making a forward delivery transaction on behalf of a selling client, a broker is required to secure the securities which are the subject of the transaction from its client, or to satisfy itself that the client is the registered holder of those securities, or has the legal right to become the registered holder of the securities, or has an irrevocable right to call for delivery of the securities to the buying client: Rule 2.9(3). The broker must also satisfy itself that the client is legally entitled or authorised to sell or dispose of the securities.

Before it makes a forward delivery transaction on behalf of a buying client, a broker is required to secure from the client an initial deposit of not less than 25% of the value of the transaction. If the value of the transaction exceeds the market price of the relevant securities at the time of the transaction, the broker is required to obtain from the buying client a further margin equal to the difference between the value of the transaction and the market value of the securities: Rule 2.9(4). If the market price of the securities changes by at least 10% of the price fixed by the forward delivery transaction, the buying broker is required to call upon its client to provide the amount necessary to maintain a margin equal to the difference between the value of the transaction and the market value of the securities: Rule 2.9(5). In effect, Rules 2.9(5) operates to ensure that the initial margin of cover of 25% obtained by the broker is maintained if the difference between the market price of the securities and the price at which the forward delivery transaction is to take place increases.

The requirement that a buying broker obtain an initial deposit and margins from the buying client reduces the exposure of the buying broker if the buyer is unable to complete at the time at which settlement of the transaction is due. If the buying client fails to provide an additional margin of cover within 1 business day after he or she is called on to do so, the broker may sell the securities which are the subject of the forward delivery transaction to the extent necessary to complete the transaction, undertaking such a sale at the client's risk: Rule 2.9(7).

E. PERSONAL LIABILITY OF A BROKER TO OTHER BROKERS AND TO CLIENTS

At common law, a contract made by an agent for an undisclosed principal is binding and enforceable against the principal if it is shown that the principal had authorised the agent to make the contract and that the contract was made in the exercise of the agent's authority.[111] An agent for an undisclosed principal is itself personally liable on a contract formed by that agent. In *Wilcox v Clarke & Co*,[112] the Victorian Supreme Court held that this principle was not displaced in dealings between brokers in accordance with the usages of the Melbourne Stock Exchange. In that case, a buying broker was held personally liable to indemnify the seller of the shares for amounts paid by the seller to satisfy calls made on

111 *Keighley, Maxsted & Co v Durant* [1901] AC 240.
112 (1896) 21 VLR 694

those shares. The analysis of transactions undertaken by brokers is complicated by the fact that a broker may enter the one transaction on behalf of several clients. In that situation, it is difficult to identify which of the broker's clients is its principal in the transaction, until the point at which the broker allocates a parcel of securities to satisfy a particular client's order.[113]

At common law, it appears that a client is not bound by, but is also unable to ratify, an unauthorised transaction undertaken by a broker if the broker did not disclose the client as its principal at the time of the transaction. The decision of the House of Lords in *Keighley, Maxsted & Co v Durant*[114] is authority that, if a contract is made by a person who intends to contract on behalf of a third party without the authority of that third party and the person who made it did not purport to be acting on behalf of a principal at the time of making the contract, the contract cannot be ratified by the third party. In *Greenwood v Martin's Bank*,[115] Scrutton LJ observed that *Keighley, Maxsted & Co v Durant*[116] established that ratification of a contract would only be effective if the act which was the subject of the ratification had in fact been done by an agent for the person who seeks to ratify it. In *Maynegrain Pty Ltd v Compafina Bank*,[117] Hope JA held that a third party cannot ratify a transaction which had been entered without his authority as being the act of his agent, if the person who entered the transaction purported to act as principal and not as agent in so doing. His Honour distinguished such cases from those where "it is known to a party that the other party is an agent, although he does not know the identity of the principal": in the latter case, the principal is entitled to ratify the contract.[118] In *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd*,[119] McHugh JA cited *Keighley, Maxsted & Co v Durant*[120] as authority that a contract cannot be made on behalf of an undisclosed principal unless the agent has the principal's authority to make the contract.[121] That general rule has the effect that, if a securities broker does not disclose its principal in entering a contract and the transaction is undertaken without the authority of its client, the broker's client is unable to ratify the transaction so as to hold the other broker or its client to the transaction.

Under Rule 5.7 of the *ASX Business Rules*, a buying broker is bound personally to pay the price of the securities to the selling broker, whether or not the buying client has placed the buying broker in funds. Conversely, the selling

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113 R Baxt, note 5 *supra*, para 8.06.

114 Note 111 *supra*.

115 [1932] 1 KB 371.

116 Note 111 *supra*.

117 [1982] 2 NSWLR 141

118 *Ibid* at 150.

119 (1987) 8 NSWLR 270.

120 Note 111 *supra*.

121 Note 105 *supra* at 276.

broker is bound personally to the buying broker to deliver the proper documents to allow the registration of the transfer, whether or not the selling client has made the documents available. The imposition of personal liability on brokers in this context reflects the usage of the Exchange, by which a broker dealing with another member does not reveal the identity of its client. A broker therefore has no opportunity to assess the credit of the client for whom another broker acts, and has to rely for completion of the transaction upon the other broker's obligation to complete the transaction irrespective of its client's failure to do so.[122] There is some support for the existence of a further usage by which a broker accepts personal liability to his or her client for the completion of the transaction.[123] Such a custom or usage would secure finality of transactions undertaken on the market and transactions reported to the market, allowing other investors to rely on a reported transaction as being a completed transaction at a particular price. The need for certainty is greater, from a client's point of view, since time is of the essence in an agreement for the purchase or sale of shares.[124] Whether such a custom or usage exists is ultimately a question of fact.

However, the decision of Cole J in *FAI Traders Insurance Company Ltd v ANZ McCaughan Securities Ltd*[125] is authority that a broker is not personally liable to its client in a special crossing within the scope of Rule 2.6(13) of the Business Rules. In that case, a selling client sought to recover the purchase price for a substantial parcel of shares from a broker, which had acted for both buyer and seller of shares in a special crossing involving deferred delivery, when settlement of the transaction did not take place. Each of the parties to the transaction had negotiated it without recognising that shareholder approval was required under Listing Rule 3J(3). Following the voluntary liquidation of the company whose shares were the subject of the transaction, an independent expert expressed the opinion that the transaction was not fair to shareholders excluding the vendor and ASX advised the purchaser that the transaction could not be put to shareholders for approval. The broker, with the purchaser's consent, purported to cancel the transaction by issuing a cancellation note to both parties. The selling client relied upon an alleged usage of ASX that the broker acted as principal to its client. Cole J held that the usage of the Exchange that a broker acting for the selling client is obliged to settle with its client and undertakes a personal and primary liability to do so did not apply to special crossings with deferred delivery, at least in circumstances where completion of the transaction did not take place because of a contravention of

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122 G Cooper and RJ Cridlan, note 12 *supra*, p 105.

123 Note 28 *supra* per Street CJ Eq at 886; by Ambrose J at first instance in *Mercantile Credits Ltd v Jarden Morgan Australia Ltd* (1990) 1 ACSR 51 at 56-57; and by Derrington J on appeal in *Mercantile Credits Ltd v Jarden Morgan Australia Ltd* (1990) 1 ACSR 805 at 809.

124 *Osborne v Australian Mutual Growth Fund* [1972] NSWLR 100.

125 Note 23 *supra*.

the *ASX Listing Rules* by one of the parties to the transaction. His Honour held that, at least in those circumstances, the broker's liability was of a secondary nature and that the broker's secondary liability ceased at the point at which the buying client relied on a contravention of the Listing Rules (including, it would seem, its own contravention of the Listing Rules) to terminate its contract with the selling client. In the writer's view, if his Honour's decision is correct on its own facts, it should not be applied outside the situation of a special crossing involving deferred delivery arrangements and a contravention of the Listing Rules by a party to the transaction.

F. RIGHTS OF BUYING AND SELLING BROKERS AGAINST THEIR CLIENTS

The fact that the broker undertakes personal liability in a purchase or sale of securities requires that it be allowed certain rights as against its client. At common law, a broker had an implied right of indemnity against its client for all reasonable expenses incurred by the broker.[126] In *W Noall & Sons v Wan*,[127] Menhennit J held that the broker's right to indemnity extended to payments already made for shares purchased by a broker, and also to payments which the broker had not yet made but was liable to make in respect of such shares. His Honour treated that right as a specific application of the principle that an agent has a right against its principal to be indemnified against losses and liabilities incurred in the course of the agency.[128] In *Shapowloff v Dunn*,[129] Stephen J held that a buying client was obliged to indemnify the buying broker against liabilities incurred by the broker on the client's behalf, and became liable to indemnify the buying broker for the purchase price of stores on the date on which the client's buying order was executed.

The broker's right of indemnity at common law is lost if the broker acts outside the bounds of the authority conferred upon it by its client.[130] For example, in *Osborne v Mutual Growth Fund Ltd*,[131] a buying client rescinded a contract of sale of shares following the sellers' delay in delivering the shares. Contrary to the defendant's instructions, the plaintiff broker accepted delivery of the shares, incorrectly believing itself to be bound to do so under the Business Rules. The Court held that the broker was not entitled to reimbursement of the price of the shares by the buying client.[132] Under agency principles, a broker's right to indemnity from its client is also lost by conduct amounting to a fraud on

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126 *Hunt, Cox & Co v Chamberlain* (1896) 12 TLR 186; *Hitchens, Harrison, Woolston & Co v Jackson & Sons* [1940] AC 266; G Cooper and RJ Cridlan, note 12 *supra*, 1971, p 141.

127 [1970] VR 683.

128 *Ibid* at 684.

129 (1980-1981) 148 CLR 72.

130 *Skelton v Wood* (1894) 71 LT 616; G Cooper and RJ Cridlan, note 12 *supra*, p 143.

131 [1972] 1 NSWLR 100.

132 *Ibid* at 114.

its principal or if the broker is party to an illegal transaction. The broker will also be denied a contractual right to reimbursement in an illegal transaction if its contract with its client fails for illegality.[133] If the broker's right to indemnity is lost, its client is entitled to recover any money paid to the broker in satisfaction of the right of indemnity, after allowing for any benefit obtained by the client.[134]

The broker's right to indemnity at common law is reinforced by Rule 3.6.2 of the *ASX Business Rules*, which authorises a buying broker to resell securities purchased for a buying client if the client fails to make payment within 10 days of despatch of the contract note. The buying broker is required to account to the client for any profit and may hold the client liable for any loss. That Rule also authorises a selling broker to buy in the securities required to meet delivery obligations to the buying broker, if the selling client fails to deliver the securities required to complete the transaction. The selling broker is entitled to hold the selling client liable for any loss. In exercising a right of resale under Rule 3.6.2, it appears that a broker must act in good faith but need not have regard to the client's interests.[135] Except in the most exceptional circumstances, the broker would satisfy its obligation of good faith by sale of the securities on market at the best available price. Rule 3.6.2 has the effect of limiting the extent to which a buying or selling broker is required to extend credit to its client if the broker has been required (under Rule 5.7) to settle with the other broker to the transaction by payment of the purchase moneys or delivery of the securities although it has not received settlement from its own client.

A broker has a lien over share certificates for shares which it acquires on behalf of a client, in support of the client's obligation to pay the purchase price of the shares. In *W Noall & Son v Wan*,[136] Menhennit J characterised such a lien as being a general lien over shares held by the broker for any amount for which the client was indebted to the broker. His Honour treated the existence of such a lien as an application of the principle of agency law which allows an agent a general or possessory lien on goods and chattels of its principal in respect of all lawful claims it may have, in its capacity of agent, against its principal.[137] It appears that the broker's lien arises at the time the contract between broker and client is made, although it cannot be enforced until share certificates are obtained by the broker. In *Mercantile Credits Ltd v Jarden*

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133 *Solloway v McLaughlin*, note 100 *supra* per Lord Atkin at 257-258.

134 Compare *North v Marra Developments Ltd* (1981) 56 ALJR 106; (1981) 148 CLR 42, where the High Court held that a broker was unable to recover fees for advice given in a transaction which involved manipulation of the price of shares in connection with a takeover, in contravention of s 70 of the Securities Act 1970 (NSW).

135 *Option Investments (Aust) Pty Ltd v Martin* [1981] VR 138.

136 Note 25 *supra*. See also *Re London and Globe Finance Corporation* [1902] Ch 416 per Buckley LJ at 420-421; G Cooper and RJ Cridlan, note 12 supra, p 146.

137 Note 25 *supra* at 685.

Morgan Australia Ltd,[138] Kelly SPJ (with whom Carter J agreed) held that the broker's lien over shares allowed the broker to retain all scrip in respect of shares which it purchased on behalf of the client until all its claims against the client were satisfied. His Honour held that the broker's lien over shares purchased on behalf of its client arose on the making of the purchase contract for those shares, notwithstanding that the shares did not come into the broker's possession until a later date. Derrington J agreed that a broker was entitled to a common law lien in the nature of a general lien, which was applicable to all shares held by the broker whether paid for or not. His Honour observed that the broker's client was bound from the time the broker was engaged to buy the shares by any lien which might subsequently arise under the engagement, and that a financier which provided finance for particular shares would take its security subject to the broker's lien for other shares purchased by the broker for the client if the broker "properly continued to buy shares for its customer and to provide credit for the immediate payment of their purchase price upon the legitimate expectation that its general lien would extend to the shares which had been paid for." On the facts, the Court held that the broker's equitable lien over shares purchased on behalf of its client took priority, as a prior equitable interest, over a later equitable charge over the shares in favour of a lender to the client of which the broker had no notice.

F. CLAIMS AGAINST THE NATIONAL GUARANTEE FUND

The National Guarantee Fund guarantees the obligations of payment or of the provision of settlement documents in respect of trades undertaken by members of the Exchange: ss 948-954. A client of a defaulting broker may claim against the Fund to cover unfulfilled obligations of a defaulting buying dealer or in respect of unfulfilled obligations of a selling dealer, and in certain circumstances may make such a claim although a member who traded on his or her behalf has been suspended by the Exchange.

A broker is also entitled to claim against the Fund provided that it has performed or is ready to perform by supplying settlement documents or by payment of the consideration. Thus, if a selling broker fails to meet its settlement obligations by failing to supply settlement documents within the completion period (as defined), s 950 provides that the buying broker may claim against the Securities Exchange Guarantee Corporation ('SEGC') provided that the buying broker has supplied or is ready, willing and able to supply the consideration for the purchase to the selling broker. Conversely, s 9[illegible](1) permits the selling broker to claim against the SEGC if at the end of the completion period (as defined) a buying broker has failed to supply the consideration for settlement of a transaction, provided that the selling broker has supplied or is ready, willing and able to supply settlement documents to the buying broker. In that case, and provided the selling broker has either supplied

138 Note 123 *supra*.

settlement documents to the buying broker or to the SEGC for the purposes of the claim, the SEGC is to pay the buying broker out of the National Guarantee Fund an amount equal to the consideration under the sale agreement: s 949(5).

Part 7.10 of the *Corporations Law* also allows an ASX subsidiary to claim against the Fund on behalf of a claimant member where the claim is authorised by the *ASX Business Rules*; and allows an ASX subsidiary to make a single claim against the Fund on behalf of several selling brokers. The Fund is available to meet claims against insolvent brokers where property was entrusted to the broker: s 963. No claim is available to a person who is merely a creditor of the insolvent broker in relation to money lent to the broker: s 966. By contrast with the fidelity funds established under Part IX of the *Securities Industry Act and Codes*, a claim against the National Guarantee Fund can be made without proof of defalcation or fraud by a broker. If the SEGC allows a claim against the Fund, it is subrogated to the claimant's rights against the defaulting broker: s 980.

The range of claims against the Fund was extended as a result of amendments made by the *Corporations Legislation Amendment Act* (No 2) 1991, in connection with proposed changes in delivery and settlement procedures adopted by ASX, including the introduction of a fixed settlement regime for securities transactions under which settlements are to take place on the 5th business day after the transaction.[139] ASX proposes to introduce a securities lending scheme to facilitate fixed date settlements. Part 7.10 Div 6A, introduced by the *Corporations Legislation Amendment Act* (No 2) 1991, will allow ASX to claim against the Fund if a broker fails to meet its obligation to pay collateral to ASX in respect of a securities loan made under the securities lending scheme to be established by ASX, or fails to return borrowed securities: s 954D. A claim against the Fund is not permitted under Part 7.10 Div 6A if the borrower's obligation to pay an amount under a guaranteed securities loan is dealt with by nett settlement: s 954E. In that case claims against the Fund are governed by Part 7.10 Div 6B.

It is proposed that ASX will adopt nett settlement of transactions between brokers, under which each broker's total obligation to deliver securities of a particular kind to other brokers will be set off against that broker's right to receive securities of that kind from other brokers in settlement of trades due to take place on a particular day. If transactions have been netted, Part 7.10 Div 6B replaces the right under Part 7.10 Div 6 to claim against the Fund in respect of each transaction with a right to claim in respect of nett obligations: s 950A. If a broker fails to discharge its obligation to pay a nett amount calculated in accordance with the *ASX Business Rules*, the broker to which the nett amount is payable is entitled to claim against the Fund: s 954N(1). Where the ASX Business Rules require a broker to transfer a nett amount of securities calculated

139 C Hamilton "T + 5: The Revolution in Stock Market Settlement" (1991) Butterworths *Corporations Law Bulletin* [389].

in accordance with the Business Rules to another broker, and the broker has failed to discharge all or part of that obligation, the broker to which securities should have been transferred is entitled to claim against the Fund if ASX has not remedied the default in settlement: s 954P(2). ASX is authorised to claim against the Fund if it has remedied the default by transferring equivalent securities to the broker to which the securities should have been transferred: s 954P(3). If nett settlement takes place by means of the FAST Interbroker Delivery Service ("FIDS"), an ineffective transfer to the buying broker is dealt with under Part 7.10 Div 6C, which governs claims against the Fund in relation to the operation of FIDS: s 954M.

Part 7.10 Division 6C allows a claim to be made against the Fund if a broker receives an ineffective transfer under FIDS, which provides a means for same-day delivery of FAST-eligible securities between capital cities. A transferee which receives an ineffective delivery through FIDS is permitted to claim against the Fund if ASX has not remedied the default: s 954X(2). ASX is subrogated to all rights and remedies of the transferee in relation to the purported transfer if it has remedied the default by transferring equivalent securities to, or as directed by, the transferee: s 954X(3). In that event, ASX is entitled to claim against the Fund in respect of its actions to remedy the default, and the broker is not entitled to claim against the Fund in respect of that default.

VII. STANDARDS OF MARKET CONDUCT

A. ACTING AS A PRINCIPAL

At general law, the broker's role as agent for its client requires that it disclose to the client if it is also acting as principal in the transaction. The broker's failure to do so entitles the client to rescind the transaction.[140] However, the client is not entitled to rescind the transaction if he or she has assented to the broker's trading as principal, after the broker has made full disclosure of the relevant circumstances.[141] The equitable principles restricting the circumstances in which a broker may deal with its client as principal are reinforced by s 843 of the *Corporations Law*. Section 843(2) prohibits a dealer from dealing in securities on its own account with a non-dealer,[142] unless it first

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140 Note 75 *supra* per McCardie J at 824, observing that "[i]t matters not that the broker sells at market price or that he acts without intent to defraud ... the prohibition of the law is absolute. It will not allow an agent to place himself in a situation which, under ordinary circumstances, would tempt a man to do that which is not best for his principal."

141 G Cooper and RJ Cridlan, note 12 *supra*, p 147 and authorities there cited; *Daly v Sydney Stock Exchange Ltd*, note 58 *supra* per Brennan J at 385; Australian Corporation Law, para [7.2.0040].

142 The term "non-dealer" is defined in s 9 as a person who is, in effect, neither a dealer nor a member of a partnership which is a dealer. Section 84 provides that a person deals in

informs the non-dealer that it is acting in the transaction as principal and not as agent. Section 843(3) requires the contract note issued by the dealer which enters a sale or purchase of securities on its own account with a non-dealer to state that the dealer is acting as principal and not as agent. A dealer which enters a transaction with a person who is not a dealer is prohibited from charging brokerage or commission for the transaction: s 843(4). If a broker deals as principal and fails to make disclosure to the client, the client is entitled to rescind the contract by notice to the dealer within 14 days after receipt of the contract note: s 843(7). The right of rescission under s 843(7) is expressly allowed in addition to other rights of the client, which would include the right of rescission in equity and the right to seek equitable compensation for breach of fiduciary duty.

Section 843 substantially coincides with Rule 3.1(2) of the *ASX Business Rules*, which provides that a broker may not deal as principal[143] in any securities with a person who is not a member of the Exchange or a member of a recognised stock exchange unless the broker first informs the person with whom it is dealing that it is acting in the transaction as principal and not as agent. A broker which enters into a transaction of sale or purchase of securities as principal with a person who is not a dealer must state in the contract note that it is acting as principal and not as agent in the transaction: Rule 3.1(3). An exception is available under Rule 3.1(3) where a broker deals as principal with a person who is a dealer. Except as permitted by the *Corporations Law* and *Corporations Regulations*, a broker which enters into a transaction of sale or purchase of securities as principal with a person who is not a dealer may not charge that person brokerage, commission or any other fee in respect of the transaction: Rule 3.1(4).

Even if a broker discloses to its client that it is acting as principal in the transaction, the reasoning of Brennan J in *Daly v The Sydney Stock Exchange*

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securities, or enters into a transaction of sale or purchase of securities, on its own account if and only if that person deals in the securities or enters the transaction as principal; on behalf of an associate of the person; on behalf of a body corporate in which the person has a controlling interest; or on behalf of a body corporate in which the person's interest and the interests of the other partners together constitute a controlling interest.

143 The class of persons to whom Rules 3.1 of the ASX Business Rules applies is extended by Rule 3.1(1)(c), which provides that a reference to a broker dealing or entering into a transaction as principal includes a broker dealing on behalf of a partner of the broker; a director, company secretary or substantial shareholder of the broker; a consultant of the broker; the Immediate Family, Family Company or Family Trust of a partner, director, consultant, company secretary or substantial shareholder of the broker; a body corporate in which the broker has a controlling interest; a body corporate in which the interests of the partners of a broker together constitute a controlling interest; or on behalf of the holding company of the broker and/or a subsidiary of that holding company.

Ltd[144] (noted above) suggests the broker remains bound by a duty to obtain the best bargain for its client which the client would obtain from a third party, if the broker was to exercise due diligence on behalf of the client in the transaction with the third party. One commentator has argued that whether the broker's duty to obtain the best bargain for its client continues after disclosure that the broker is acting as principal will depend upon the circumstances of each case, including factors such as the relative investment sophistication of the client and inferences drawn from prior dealings between the broker and its client.[145] It may be that the question is not one of the existence or non-existence of a continued duty of the broker to make the best bargain for its client, but of the scope of that duty. It is arguable that the scope of that duty would be less exacting in circumstances where the client was, for example, an institutional investor.

B. PRECEDENCE OF CLIENT ORDERS

As fiduciary, a broker is not permitted to enter the market and trade in competition with its clients. In *Hewson v Sydney Stock Exchange Ltd*,[146] Street J observed that a "fundamental principle of commercial morality will be gravely compromised" by such conduct.[147] Section 844 of the *Corporations Law* is a statutory recognition of a broker's fiduciary duty not to compete with its client. Section 844(2) provides that a dealer may not enter a transaction in securities traded on a stock market of a securities exchange if a client, who is not an associate of the dealer, has instructed the dealer to buy or sell securities of the same class and that transaction has not been completed. The prohibition under s 844(2) is subject to an exception under s 844(3), where the dealer has been unable to buy or sell the securities as a result of instructions from the client which required the purchase or sale to be effected only on specified conditions relating to price.

Rule 5.6 of the *ASX Business Rules* is similar in scope to s 844, and prohibits a broker buying or selling securities on its own account or on the account of a prescribed person (as defined in Rule 5.6(1)) if the broker holds an unexecuted order from a client to deal in one or more marketable parcels in those securities on the same terms. Rule 5.6(4) provides that a limit order which cannot be executed owing to price differences is not uncompleted for the purposes of the Rule. Rule 5.6 of the Business Rules establishes that a client's order takes precedence over trading by the broker or its associated persons on the same terms. However, that rule does not establish the order in which the broker is to execute orders on behalf of its clients. By contrast, Rule 5.15 of the *Financial Services (Conduct of Business) Rules* 1987 (UK) not only requires a broker to

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144 Note 58 *supra*, per Brennan J at 385.

145 *Australian Corporation Law*, para [7.2.0040].

146 Note 76 *supra*.

147 *Ibid* at 231.

execute a client's order prior to a similar transaction in the same securities on its own account, but also requires the broker to execute such an order prior to executing the instructions of another client received after the first instruction, and prior to carrying out a decision made by the broker on behalf of another customer in handling a discretionary account.

A further exception to the prohibition under s 844 of the *Corporations Law* is available for a transaction entered into in prescribed circumstances. Those circumstances are defined by reg 7.4.05 of the *Corporations Regulations*, which provides that s 844(2) does not have effect in relation to transactions entered into by a member of a stock exchange in accordance with the business rules of that exchange. Rule 5.6(4) of the Business Rules in turn permits a broker to trade on its own account, although an order from a client is unexecuted, if the broker confines its activities to Professional Investors (as defined) and executes each transaction "to the best advantage" of the Professional Investor.[148] Section 844 does not allow the client a statutory right to damages for breach of a broker's obligation to give priority to the client's order. However, a client could seek compensation for breach of that obligation on the ground that such a breach contravened the fiduciary duty owed by the broker to its client. Alternatively, a client could seek damages under s 1324 of the *Corporations Law* on the basis that the Court would have had power to grant an injunction to restrain the broker from contravening s 844 of the *Corporations Law* by failing to give priority to its client's order.[149]

C. BROKER'S ALLOCATION POLICY

It is generally sufficient compliance with the broker's duty to its client that the broker obtains possession of an equivalent number of shares to those required under the contract allocated to a particular client. In *Solloway v McLaughlin*,[150] Lord Atkin observed that a broker is not obliged to deliver to its client the specific shares which are delivered to the broker under a contract which it enters on behalf of its client, provided that the broker takes possession of and retains an equivalent number of shares. However, there is some authority that the broker's duty to its client requires that it retain the particular

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148 The term 'Professional Investor' is defined in the definitions section of the Business Rules as "a client whose ordinary business is to buy or sell securities whether as principal or agent", and expressly includes life insurance companies; general insurance companies; superannuation funds; banks; merchant banks; investment companies and trusts; companies and trusts with net assets of not less than $30 million at the date of their last published audited balance sheet, which are on the Official List of the Exchange or on the Official List of the Second Board of a State Subsidiary or are listed on a Stock Exchange recognised by ASX, and companies related to such companies and trusts.

149 *Australian Corporation Law*, para [7.2.0045].

150 Note 100 *supra* per Lord Atkin at 256; R Baxt, note 5 *supra*, pp 805-806; *Australian Corporation Law*, para [7.1.0790].

shares delivered by the selling broker in relation to each buying client, at least where the orders are for securities the price of which is rising on market.[151] It is obviously necessary for the broker to exercise a discretion as to allocation where some client orders are subject to price limits which restrict their execution.

Rule 3.3 of the *ASX Business Rules* requires a broker to advise its client of the policy adopted by the broker in relation to the allocation of securities to fulfil orders placed with it, but only upon the client's request. If the broker adopts a policy of switching securities by using scrip delivered under a contract allocated to one client to make delivery upon earlier contracts, compliance with Rule 3.3 requires that the broker advise its client upon request that it adopts that policy. Rule 5.6(7) of the *ASX Business Rules* further provides that a broker which allocates a sale or purchase of securities to fulfil all or part of an order from a prescribed person for its own account, when it has an unfulfilled order on the same terms for those securities from a client, is regarded as having engaged in conduct to which Article 52 of the *ASX Articles of Association* applies. Article 52 empowers the ASX Board to charge a member with prohibited conduct, being conduct which is not efficient, honest or fair or is otherwise prejudicial to the interest of the exchange or its members.

D. PROHIBITION OF ADVICE TO CLIENT WHERE BROKER POSSESSES INSIDE INFORMATION

If a broker, as a result of its relationship to a client, possesses information that is not generally available in relation to a security and which would be likely to materially affect the price of the security if it were generally available, Rule 3.5 of the *ASX Business Rules* prohibits that broker from giving advice to any other client of a nature that would damage the interest of either of those clients. Rule 3.5(3) allows an exception to that prohibition where the broker has a Chinese wall in place and the person advising its client does not possess the relevant information. In order to rely on that exception, the broker must previously have advised the Exchange in writing that it has created Chinese walls in accordance with the guidelines prescribed by the Exchange; that the Chinese walls will not be removed or altered without prior advice to the Exchange; and that the broker requires the Exchange to place its name on a register of brokers maintaining Chinese walls which is made available by the Exchange for public perusal. Paragraph 1 of Section 5 of the proposed ASX Code of Conduct appears to mandate the adoption of Chinese Wall procedures by brokers, by requiring member organisations to take "all reasonable steps" to ensure that "they have in place internal controls and procedures and sensitive information is isolated from areas where its possession could lead to conflicts of interests and, in this regard, the different parts of the business operate independently."

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151 *Constable v Meyer* (1972) 3 DCR 41.

Rule 3.5 and Section 5 of the proposed ASX Code of Conduct should be read together with Division 2A of Part 7.11 of the *Corporations Law*, as amended by the *Corporations Law Amendment Act* 1991. Rule 3.5 is limited to the offering of advice by a broker to its client, while the statutory provision extends further to the execution of dealings upon the client's instructions. Section 1002G(2) prohibits an insider from subscribing for, purchasing or selling, or entering an agreement to subscribe for or purchase or sell securities or procuring another person to do so. Section 1002S provides that the holder of a dealer's licence ('agent') does not contravene s 1002G(2) by subscribing for, purchasing or selling, or entering an agreement to subscribe for or purchase or sell securities traded on the exchange if:

- the agent entered into the transaction or agreement on behalf of another person ('principal') under a specific instruction by that person to do so;
- the dealer had in place, at the time of entry into the transaction or agreement, arrangements that could reasonably be expected to ensure that any information in the possession of the dealer or of any representative of the dealer, as a result of which the person who possessed the information would have been prohibited from entering the transaction or agreement under s 1002G(2), was not communicated to the agent and that no advice with respect to the transaction or agreement was given to the agent by a person in possession of the information;
- the information was not so communicated and no such advice was given; and
- the principal was not an associate of the holder of the dealer's licence or of any of its representatives.

There are significant differences between s 1002S and the former s 1002(10), which did not require that a chinese wall[152] existed so as to prevent inside information possessed by a broking firm being communicated to the broker executing the trade, provided that no advice was given by the dealer to its client. By contrast, the defence under s 1002S is available even if the dealer has given advice to its client in relation to the purchase; but requires that a chinese wall is in place to ensure that the representative who possessed the inside information did not communicate that information to the representative who gave advice to the client.

As a matter of practice, there is some advantage to a broking firm in ceasing to advise its clients in respect of a security if it comes into possession of

152 As to the legal significance of chinese walls, see "Note" (1974) *Harvard LR* 396; M Lipton and R Mazur, "The Chinese Wall Solution to the Conflict Problems of Securities Firms" (1975) 50 *New York University LR* 459; TA Levure, AZ Gardiner and LD Swanson, "Multiservice Securities Firms, Coping with Conflict in a Tender Offer Context" (1988) 23 *Wake Forest LR* 41; A J Black, "Policies in the Regulation of Insider Trading and the Scope of Section 128 of the Securities Industry Code" (1988) 16:3 *MULR* 633 at 658-662.

material non-public information concerning that security, even if a chinese wall is in place. The practice of ceasing to advise avoids the possibility that a representative could recommend a purchase of shares to a client on the basis of publicly available information, while another department of the broking firm possesses inside information indicating that the recommendation is ill-advised. A further difficulty arises if a broker or investment adviser is under a duty to its client to use all material information in its possession in offering investment advice, including inside information possessed by an employee and attributed to the firm under agency principles. The American courts have refused to allow a broker which is under conflicting duties to justify non-disclosure of material information to clients by asserting conflicting obligations which it has brought upon itself.[153] However, there is a strong argument that there can be no breach of fiduciary duty by a broker in not revealing insider information to its client, since that duty cannot require the breach of the broker's obligations under the *Corporations Law*. Moreover, if a broking firm has advised a client that it has a chinese wall in place, it is arguable that the scope of the broker's fiduciary duty to that client is restricted so as not to require disclosure of information which is attributed to the firm because it is in the possession of one department, where the chinese wall prevents disclosure of that information to the representative offering advice to the client.[154]

E. FRAUD ON THE MARKET

Paragraph 4 of Section 3 of the proposed ASX Code of Conduct requires that brokers refrain from actions which would conflict with the objective of an "orderly, open, fair and visible market". That requirement receives more specific expression in Rule 2.8 of the *ASX Business Rules*, which prohibits a broker from making bids or offers for securities "with the intention of creating a false or misleading appearance with respect to the market for, or the price of, any Securities" or making a transaction or giving an order for the purchase or sale of securities "the execution of which would involve no change of beneficial ownership, unless the Member or Broker had no knowledge that the transaction would not involve a change in the beneficial ownership of the Securities." The first limb of Rule 2.8 should be read in the light of s 998(1) of the *Corporations Law*, which prohibits transactions involving market manipulation, including

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153 *Black v Shearson Hammill & Co* 22 Cal App 2d 363 (1968); *Slade v Shearson Hammill & Co* 517 F 2d 398 (1974); SR Hunsicker, "Conflicts of Interest, Economic Distortions, and the Separation of Trust and Commercial Banking Functions" (1977) 50 *Southern California Law Review* 611 at 636, 638.

154 M Lipton & R Mazur, note 150 *supra* at 475; L Herzel & De Colling, "The Chinese Wall and Conflict of Interest in Banks" (1978) 34 *Business Lawyer* 73 at 89; Black, note 150 *supra* at 661. As to the restriction of the scope of fiduciary duty in Australian law, see *Birtchnell v Equity Trustees, Executors and Agency Limited* (1929) 42 CLR 384 per Dixon J at 408 and *NZ Netherlands Society v Kuys* [1973] 2 All ER 1222 per Lord Wilberforce at 1225-6.

transactions which are intended to or likely to create a false or misleading appearance of active trading in any securities on a stock market or a false or misleading appearance with respect to the market for or the price of securities. The second limb of Rule 2.8, dealing with transactions which involve no change of ownership, covers substantially the same ground as s 998(3), which prohibits purchases or sales of securities which do not involve a change in the beneficial ownership of the securities and which have an effect upon the market price of the securities.

The case law in relation to market manipulation offers further assistance as to the scope of the broker's obligations under Rule 2.8.[155] In *North v Marra Developments Ltd*,[156] the appellants were members of a broking firm which participated in a scheme to establish a market for shares in the capital of the respondent at a particular price in order to facilitate a takeover. The High Court considered the scope of the prohibition in s 70 of the *Securities Industry Act* 1970 (NSW), the predecessor of s 998, which in effect prohibited trading activity creating a false or misleading appearance of the market for or the price of securities. Mason J noted that the object of s 70 was "to protect the market for securities against activities which will result in artificial or managed manipulation", and that "[i]t is in the interests of the community that the market for securities should be real and genuine, free from manipulation".[157] These provisions should be compared with s 9(a)(2) of the *Securities Exchange Act* 1934 (US), which makes it unlawful for any person, alone or with others, to effect a series of transactions in any security listed on a national exchange which creates actual or apparent active trading in the security, or raises or lowers its price, for the purpose of inducing others to purchase or sell the security; and with s 15(c) of the *Securities Exchange Act*, which prohibits fraudulent and manipulative conduct by broker-dealers in transactions on the stock exchanges and on the over-the-counter markets. In *Santa Fe Industries v Green*,[158] the US Supreme Court held that a transaction which was specifically intended to artificially affect the price of a security would amount to market manipulation.

Certain kinds of fraud on the market undertaken by a broker, such as the practice of 'scalping' described in the American cases, would fall outside the scope of Rule 2.8 of the *ASX Business Rules*. 'Scalping' occurs if a broker purchases a security prior to recommending the purchase of that security to clients, and then sells the security after the price has increased in response to purchases by clients. In American law, such conduct gives rise to a right of

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155 G Hart, "The Regulation of Stock Market Manipulation" (1979) 7 *ABLR* 139; PWR Meyer, "Fraud and Manipulation in the Securities Markets: A Critical Analysis of Sections 123 to 127 of the Securities Industry Codes" (1986) 4 *C&SLJ* 92.

156 Note 133 *supra*.

157 *Ibid* at 112.

158 430 US 462 at 476 (1977).

action against the broker under the shingle theory.[159] 'Scalping' has also been characterised in American law as fraudulent conduct in connection with the purchase and sale of securities, which gives rise to a right of action under Rule 10b-5 made under the *Securities Exchange Act* on the basis that such conduct involves 'a scheme to manipulate the market and deceive the investing public'.[160] Conduct by a broker amounting to 'scalping' would amount to a breach of fiduciary duty under Australian law. Such conduct would also constitute 'prohibited conduct' for the purposes of Article 52 of the *ASX Articles of Association*, authorising ASX to suspend the broker's membership of the Exchange or to expel it from membership.

F. CHURNING

In the practice known as 'churning', a dealer generates transactions in a client's account that are excessive in amount and in number having regard to the character of the account in order to increase its commission income. The profitability of trading to the client is not necessarily increased and may well be decreased by an increase in the number of transactions undertaken on the client's account. The risk that a broker will 'churn' a client's account reflects the conflict between the broker's interest and that of its client which is implicit in the remuneration of brokers by commission for transactions undertaken as agent, which allows the broker to profit from a transaction although the client has suffered a loss on that transaction.[161] That risk increases if the client authorises the broker to operate a discretionary account, where the broker makes trading decisions on the client's behalf. The client's purposes in allowing its broker a discretion to make trading decisions would clearly be frustrated if, rather than the broker acting in the client's interest in making those decisions, it conducted the account so as to maximise its commission income. The prohibition on churning can therefore be characterised as protecting the reliance interest of a client who confers an investment discretion on a broker within an ongoing broker-client relationship.[162]

There is American authority which establishes the elements of an action against a broker for churning. In *Merrill Lynch, Pierce, Fenner & Smith v Arceneaux*,[163] the Court suggested that churning occurred where a securities broker bought and sold securities for a customer's account without regard to the customer's investment interest, for the purpose of generating commission. In

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159 *SEC v Capital Gains Research Bureau Inc* 375 US 180 (1963), *Zweig v Hearst Corp* 594 F 2d 1261 (9th Cir 1979)

160 *Zweig v Hearst Corp*, *ibid* at 1271; TL Hazen, *The Law of Securities Regulation* (1985) p 280.

161 PA O'Hara, "The Elusive Concept of Control in Churning Claims under Federal Securities and Commodities Law" (1987) 75 *Georgetown LJ* 1875 at 1875.

162 *Ibid* pp 1882, 1893.

163 767 F 2d 1498 (11th Cir 1985).

Mihara v Dean Witter & Co,[164] the court held that a claim for churning would be established if the plaintiff showed that trading in his account was excessive having regard to his or her investment objectives; the broker exercised control over trading in the account; and the broker acted with the intent to defraud or with wilful and reckless disregard for the interests of the client. Section 15(c) of the *Securities Exchange Act* 1934 (US) prohibits brokers and dealers from participating in manipulative, deceptive or fraudulent acts and practices in connection with sales or attempts to induce the sale of securities. Rule 15C1-7 defines the term "manipulative, deceptive or other fraudulent device or contrivance" to include "any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account" if a broker or dealer is vested with discretionary power over a client account, and is therefore also available in an action for churning under American law.[165] There is authority that churning of a customer's account also amounts to a breach of Rule 10b-5 made under the *Securities Exchange Act* 1934 (US) on the ground that the broker-dealer which does not inform its customer that trading activity in the customer's account is excessive, in the light of a customer's financial circumstances and investment objectives, is guilty of a material failure to disclose in connection with the purchase or sale of securities.

Rule 3.4.2 of the *ASX Business Rules* deals with 'churning', and treats a broker as having engaged in conduct to which the provisions of Article 52 of the *ASX Articles of Association*[166] apply if the ASX Board considers that the broker has effected an excessive number of transactions on behalf of clients for whom the broker manages or operates a discretionary account or managed fund. A similar prohibition of the practice of churning is contained in Rule 2.08(2) of the *Financial Services (Conduct of Business) Rules* 1987 (UK), which provide that a firm which exercises a discretion in respect of the investment of a customer's funds must not effect transactions with unnecessary frequency or in excessive size. Rule 2.08(3) provides that a firm must not make recommendations to any of its customers which are likely to lead to transactions being effected by the firm with unnecessary frequency or size.

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164 619 F 2d 814 at 821 (9th Cir 1980). A similar definition was adopted in *Thompson v Smith Barney, Harris Upham & Co* 709 F 2d 1413, 1416 (11th Cir 1983) and in *Hancock v Edward D Jones & Co* 750 F 2d 767 at 775 (9th Cir 1984).

165 *Kravitz v Pressmar, Frohlich & Frost Inc* (1978) 447 F Supp 203; M Slonim, "Customer Sophistication and a Plaintiff's Duty of Due Diligence: A Proposed Framework for Churning Actions in Non-Discretionary Accounts under SEC Rule 10b-5" (1986) 54 *Fordham LR* 1101; MG Hains, "Churning and Burning: A Futures Cause of Action" (1989) 63 *ALJ* 608; R Baxt, note 5 *supra*, para 1308; *Australian Corporation Law*, para [7.1.0835].

166 Article 52, which is discussed below, empowers the ASX Board to charge a member with prohibited conduct, being conduct which is not efficient, honest or fair or is otherwise prejudicial to the interest of the exchange or its members.

In order to establish a breach of Rule 3.4.2, it would be necessary to show that the trading in the discretionary account was excessive, and arguably would also be necessary to show that the customer did not consent to the excessive trading. To determine whether the number of transactions in the account was excessive, the ASX Board would be required to consider the character of the particular discretionary account; the trading needs of the client for whom the account was operated; and whether there was a substantial disparity between the turnover in the relevant account and the normal trading patterns for similar accounts. The turnover of an account may be determined by comparing the total cost of purchases made over the relevant period in that account to the amount invested by the client. That comparison indicates the number of times in that period in which securities held by the client have been replaced by newly acquired securities.[167] The American cases have suggested that a broker which turns over an account in excess of six times in a year is likely to have engaged in excessive trading.[168] That conclusion will partly depend upon the investment objectives of the particular client, since a higher level of trading would be expected in an account operated for a client whose investment objectives were speculative.[169] The level of annual turnover of the account which would suggest the existence of churning may also depend upon local market conditions, and would not necessarily be the same for shares traded on ASX as for shares traded on the American stock exchanges. Other evidence which may suggest the existence of churning includes a particularly high volume of commission earned on a client's account by comparison with other accounts managed by the same broking firm or by other brokers[170] and the ratio between the commission earned by the broker and the size of the account.[171]

A broker's conduct would not breach Rule 3.4.2 if the broker did not operate a discretionary account or managed fund on the client's behalf, but advised its client to undertake an excessive number of transactions, assuming that the client made the operative decision to trade on each occasion. By contrast, a broker's control of a client's account may be established under American law, for the purposes of a churning action, not only where the broker has express discretionary authority to make trading decisions, but also by the relationship between the broker and its client.[172] The American cases hold that 'de facto' control of the client's account can be established if the client relies as a matter

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167 Note 161 *supra* at 1891.

168 *Mihara v Dean Witter & Co*, note 163 *supra*.

169 *Follansbee v Davis, Skaggs & Co* 681 F 2d 673, 676 (9th Cir 1982); *Costello v Oppenheimer & Co* 711 F 2d 1361, 1368 (7th Cir 1983); note 160 *supra* at 1891.

170 T L Hazen, note 160 *supra*, p 284.

171 *Costello v Oppenheimer & Co*, note 169 *supra*; Slonim, note 165 *supra* at 1105.

172 *Tiernan v Blyth, Eastman, Dillon & Co* 719 F 2d 1 (1st Cir 1983); TL Hazen, note 160 *supra*, p 283; LD Soderquist, *Understanding the Securities Laws* (1987) pp 297-298.

of course on a broker's recommendations.[173] In determining whether such control exists, the American courts have looked to whether the broker rather than the client typically initiates trades in the account; to whether the client exercises independent judgment as to trading decisions, for example by rejecting the broker's recommendations from time to time; and to the level of the client's knowledge and experience in the securities market.[174]

In Australian law, circumstances involving 'churning' of a client's account are likely to constitute a breach of the broker's fiduciary duty to its client. That duty would be particularly demanding if the broker is permitted to trade in its discretion, or if it can be shown that the client typically accepts the broker's advice as to whether to undertake a trade.

There are real difficulties as to the proper measure of equitable compensation which should be allowed to a client in an action against a broker for breach of fiduciary duty which arises from churning of the client's account. The measure of damages adopted by American courts in churning actions has typically been the loss suffered by the client in excessive commission payments, plus accrued interest on such payments.[175] In *Mihara v Oppenheimer & Co Inc*,[176] the Court noted the result of churning was to cause loss to the client by way of excessive commissions paid to the broker, but also recognised the possibility that the client might suffer as a result of a decline in the value of his or her holding if transactions undertaken by the broker for the purpose of generating commission were not suitable for the client's objectives. The Court held that the client could recover compensation for the decline in the value of its holdings under the *Securities Exchange Act* 1934 (US) and in an action for breach of fiduciary duty. In *Hancock v Edward D Jones & Co*[177] the Court held that damages in an action for churning would include both excessive commissions paid to the broker and the decline in value of the client's investment portfolio resulting from the transaction. The American courts have held that a client who had made a profit on his or her trading would nonetheless be entitled to recover commissions paid on excessive transactions in the client's account.[178]

Since the existence of excessive trading does not necessarily indicate that a broker has made unsuitable investment decisions, it may be that damages should be limited to the amount of excessive commission earned by the broker, unless it can also be shown that the particular investment decisions made by the broker were unsuitable to its client's requirements. If that can be shown, it is arguable that the client should also recover the decline in the value of his or her securities portfolio, to the extent that such decline exceeds any decline in the

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173 M Slonim, note 165 *supra* at 1105.

174 *Tiernan v Blyth, Eastman Dillon & Co*, note 170 *supra* at 3-4.

175 *Hecht v Harris, Upham & Co* 430 F 2d 1202 (9th Cir 1970).

176 637 F 2d 318 (5th Cir 1981).

177 Note 164 *supra* at 774.

178 *Nesbit v McNeil* 896 F 2d 380 at 385 (9th Cir 1990); JD Cox, note 71 *supra*, pp 1232-1233.

market as a whole.[179] On the other hand, it has been argued that an award of damages to a client for a reduction in the value of his or her portfolio has the effect that the broker is required to share in the client's investment risk, even if the broker is only held liable for the decline in the value of the client's portfolio to the extent that it exceeds a decline in the market as a whole. This result is said to arise since proceedings are only likely to be commenced by clients whose investment results are worse than those of the market generally, whereas the broker does not share in profits made by other clients whose investments performed better than the market generally.[180] One Australian commentator has argued that damages for churning should be assessed by determining the level of trading which would have been appropriate for the client's account in all the relevant circumstances, having regard to the level of risk which the client was willing to undertake in the account. That commentator suggests that trades above that appropriate level of trading should be treated as excessive; and that the client should be compensated for commission relating to the excessive trades, but should not be compensated for commission paid in trades initiated by the client or trades which were appropriate for the account having regard to the relevant circumstance.[181] By contrast, the American cases have not generally allowed an allowance for commission which would have been earned by a broker who had undertaken a normal volume of trading. The approach adopted in the American cases recognises the practical difficulty of distinguishing transactions which are excessive from those which would not have been excessive on a case-by-case basis.[182]

G. TRADING BY EMPLOYEES

Given the possibility of inadequate credit control and of conflict of interest if employees of a broker were permitted to trade in securities at the expense of the broker, the extension of credit in relation to trading to employees involves a greater risk to the liquidity position of a broker than the extension of credit to clients at arm's length. The *Corporations Law* imposes restrictions on the extent to which dealers may provide credit to employees. These restrictions have the primary purpose of preserving the liquidity of broking firms. The restriction on extending credit to employees has the incidental effect of restricting the opportunity for employees to trade in competition with clients of the broker.[183]

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179 *Mihara v Oppenheimer & Co*, note 176 *supra*; TL Hazen, note 160 *supra*, p 285.

180 FH Easterbrook and D R Fischel, "Optimal Damages in Securities Cases" (1985) 52 *Uni Chicago LR* 611 at 648-649.

181 RG Hains, note 165 *supra* at 617.

182 RW Jennings and H Marsh, note 7 *supra*, p 640.

183 P Redmond, *Companies and Securities Law: Cases and Materials* (1988) p 615; R Baxt, note 5 *supra*, pp 117-118.

Section 845(3) of the *Corporations Law* prohibits a dealer from giving credit to an employee or an associate of an employee, if the credit is given for the purpose of enabling or assisting the employee or his or her associate to buy or subscribe for securities, or if the dealer knows or has reason to believe that the credit will be used for the purpose of buying or subscribing for securities. It is clear that the giving of credit by a broker to its employee in contravention of s 845(3) can occur without the broker having extended an additional period to employees of the broker beyond that which is allowed to other clients of the broker.[184]

Section 845(4) prohibits a person who is an employee of a broker "in connection with a business of dealing in securities" carried on by the broker from buying or agreeing to buy securities or rights or interests in securities unless the firm acts as agent of that person in respect of the transaction. That section is limited to the purchase of securities, and does not apply to their sale. That limitation is inconsistent with the policy of ensuring that trading occurs in-house so that a broker may monitor trading by its employees to ensure that they do not trade on the basis of market information obtained as an employee of the firm. However, the fact that s 845(4) does not extend to sales of securities is of lesser significance in the light of Rule 5.11 of the *ASX Business Rules*, which prohibits a broker from buying or selling securities for any person who is an employee, consultant or an associated member of another broker or for their Immediate Families, Family Companies and Family Trusts (as defined), except where the broker receives a prior waiver from the Exchange. The effect of this prohibition is to ensure that trading by employees of broking firms occurs 'in-house', and thereby to allow the broking firm to monitor that trading to identify misuse of price-sensitive information acquired by employees in the course of their duties with the firm, or market manipulation by employees.

Section 845(6) extends the definition of 'employee' for the purposes of s 845(4) to include officers of an incorporated broker. Section 845(4) therefore applies to purchases of securities made by an executive director of a broker who is engaged in an operational capacity in the securities business of that broker. It is not clear that this prohibition would extend further to, for example, a non-executive director of an incorporated broker who has no operational involvement in the securities business of the broker. Section 845(4) applies only to a person who is an employee or officer of the broker "in connection with a business of dealing in securities" carried on by the broker. Arguably, the fact that a person is a director of an incorporated broker does not in itself establish a connection with the broker's business of dealing in securities.

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184 As to the point at which a broker gives credit to an employee, see *Australian Corporation Law*, para [5.1.075].

H. REGISTER OF INTERESTS IN SECURITIES[185]

Part 7.7 of the *Corporations Law* requires a broker, and any employee of the broker who holds a proper authority issued by the broker, to maintain a register containing particulars of relevant interests in securities. The term "securities" is defined in s 879(1), for the purposes of Part 7.7, as securities of a public company or of a body corporate or other person included in the official list of a securities exchange. For present purposes, the term "relevant interest" is defined in Part 1.2 Division 5. Prescribed particulars of the securities and of the nature of the interest must be entered by the broker or holder of the proper authority in the register within a specified period of the time the broker or holder of the proper authority comes within the scope of Part 7.7 or becomes aware that he or she has a relevant interest in securities: s 881. The prescribed particulars include the date on which the broker or holder of a proper authority began or ceased to have the relevant interest or on which a change in the relevant interest occurred; the number of securities to which the relevant interest relates; the amount of the consideration for the acquisition, disposal of or change in the relevant interest, including the nature of any non-monetary consideration; and details of any nominee holding the securities.

VII. OBLIGATIONS OF BROKERS IN MAKING SECURITIES RECOMMENDATIONS

A. RECOMMENDATIONS BY BROKERS AND THEIR REPRESENTATIVES: DISCLOSURE OF INTERESTS

It was noted above that a broker is obliged, as fiduciary, to disclose the nature of any interest which it has in securities which it offers to a client. The decision in *Daly v Sydney Stock Exchange*[186] suggests that a broker which discloses its interest in a transaction is under a continuing duty to give its client the best advice which it could have given if it had no interest in the transaction. The obligations of a broker as to disclosure of its interest in a transaction are reinforced by s 849 of the *Corporations Law* and by the *ASX Business Rules.*

Section 849 of the *Corporations Law* requires a securities adviser (defined in s 9 to include a dealer or a securities representative of a dealer) to disclose matters which may influence a recommendation to a client. In the case of an oral recommendation, that disclosure is to be made orally. Section 849 requires a broker to disclose a commission or fee or other benefit or advantage that the broker or an associate receives in connection with making the recommendation, or in connection with a dealing by the broker's client in securities as a result of the recommendation; and any other pecuniary or other interest of the broker or an associate of the broker that may reasonably be expected to be capable of

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185 *Australian Corporation Law*, paras [7.1.1615] - [7.1.1635].

186 Note 58 *supra.*

influencing the broker in making the recommendation. Section 849(3) excludes commission or fees which the broker receives from the client from the disclosure obligation. It will be a question of fact whether a particular interest of the broker would be capable of influencing the broker and its representatives in making a recommendation. By way of example, a significant holding of securities as principal or the fact that securities are the subject of an underwriting agreement to which the broker or a related company is party are matters which should be disclosed. Section 849 of the *Corporations Law* can be compared with Rule 5.08(1) of the *Financial Services (Conduct of Business) Rules* 1986 (UK), which provides that a firm must not effect a transaction in investments with a customer who is not a market counterparty or an execution-only customer, and must not recommend a transaction to a customer who is not a market counterparty, if the firm has a direct or indirect material interest in the transaction or has a relationship with another person which puts the firm in a position where its duty to, or interest in relation to, that other person conflicts with its duty to its customer. That rule allows an exception if the agreement between the firm and its customer expressly states that the firm may enter into transactions which give rise to a conflict of interest or duty on its part without prior reference to the customer.[187] There is no similar exception under s 849 of the *Corporation Law*.

Section 850(1) allows a defence to a contravention of s 849 if the broker was not aware and could not reasonably have been expected to have been aware of the interest at the time the recommendation was made. It is likely that this defence will only be available if reasonable enquiries would not have revealed the information to the broker. Section 850(2) allows a defence to a contravention of s 849 if a securities broker has a chinese wall, or other internal procedures to prevent communication of sensitive information, in place; if the person who made the recommendation was not aware of the interest; and if no advice was given to the person who made the recommendation by any other person who knew of the interest. Section 852 imposes civil liability on a broker which contravenes s 849 by failing to disclose an interest, if a client relied on the broker's recommendation, that reliance was reasonable and the client suffered loss. A defence to civil liability is available under s 852(3) if the broker establishes that a reasonable person in the client's circumstances would have acted in reliance on the recommendation even if the broker had properly disclosed its interest.

Paragraph 2 of Section 5 of the proposed ASX Code of Conduct would prohibit a broker advising or dealing in relation to a transaction unless it has fairly disclosed a material interest in the subject matter of that transaction to the client, subject to a recognition of chinese walls. That principle overlaps with brokers' statutory obligations under s 849 of the *Corporations Law*.

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187 RR Pennington, note 110 *supra*, p 117.

B. RECOMMENDATIONS BY BROKERS AND THEIR REPRESENTATIVES: SUITABILITY OBLIGATIONS

Section 851 of the *Corporations Law* is contravened if a broker makes a securities recommendation to a person who may reasonably be expected to rely on it and does not have reasonable grounds for making that recommendation. Section 851(2) has the effect that a broker is presumed not to have had a reasonable basis for making a recommendation unless it has had regard to the information it has about the client's investment objectives, financial situation and particular needs; has given such consideration to and conducted such investigation of the subject matter of the recommendation as is reasonable in all the circumstances; and the recommendation is based on the consideration and investigation. Section 851 of the *Corporations Law* may be compared with Rule 405 of the New York Stock Exchange, which imposes a "know your customer" obligation on members of the Exchange in relation to sales of securities and recommendation of securities. Section 2 of Article III of the *Rules of Fair Practice of the National Association of Securities Dealers* (US) requires a broker which recommends a purchase or sale of a particular security to a customer to have "reasonable grounds for believing that the recommendation is suitable for such a customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs". That rule does not expressly require the broker to investigate its client's investment objectives, although it requires the broker to make a recommendation which has a reasonable basis having regard to information provided by the client.[188]

Rules 3.01 and 5.01 of the *Financial Services (Conduct of Business) Rules* 1986 (UK) similarly prohibit a firm which carries on an investment business from making a recommendation to a client or exercising a discretion on the client's behalf unless the firm "has reasonable grounds for believing that the transaction is suitable for the customer, having regard to what the firm knows or ought to know about his other investments and his personal and financial situation". This provision implicitly requires a broker to obtain information about its client's financial position. Rule 5.01(2) provides that a broker cannot effect a transaction for a client which the broker believes to be unsuitable for that client, unless the broker advises its client not to proceed and the client indicates that he or she wishes to proceed with the transaction despite the broker's advice. Rule 1.04(1) of the *Financial Services (Conduct of Business) Rules* 1986 (UK) allows an exception from the suitability obligation if the firm reasonably believes its client to be a business investor, an experienced investor or a professional investor in relation to the transaction; if the firm's client is a market counterparty in relation to the transaction; or if the client is an execution-only client. Section 851 of the *Corporations Law* does not allow an express exemption for recommendations made to a professional investor. It will

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188 TL Hazen, note 160 *supra*, pp 275-276.

be a question of fact if, in the particular circumstances, a professional investor is a person who may reasonably be expected to rely on a securities recommendation made by a broker.[189]

There is American authority as to the scope of the requirement that a broker have reasonable grounds for a recommendation to its client. In American law, the broker's obligation to have a reasonable basis for its recommendation has been treated as a specific application of the 'shingle' theory. In *Hanly v Securities and Exchange Commission*,[190] the Court noted that the relationship of broker and client gave rise to an implicit representation that a broker had an adequate basis for a recommendation made to its client; and that the making of a recommendation implied that the broker had made a reasonable investigation of the securities and that its recommendation was based on that investigation. The Court held that, where a broker's representative lacked information about a security which was necessary to reach an informed recommendation, he or she should disclose that fact to the client and should also disclose the risks which followed from that lack of information. In *Rolf v Blyth Eastman, Dillon & Co*,[191] the Court treated the broker's duty to investigate the securities which were the subject of its recommendation as arising from the representation implied by the broker-client relationship that the broker would exercise due diligence in relation to such a recommendation. The broker's duty to have a reasonable basis for its recommendation has also been characterised by American courts as arising from the broker's duty to exercise reasonable care.[192]

Prima facie, whether the broker has reasonable grounds for a recommendation will be tested both against the broker's investigation of the securities which are the subject of the recommendation, and against the broker's knowledge of the investment objectives and financial circumstances of the client to whom the recommendation is made. On its face, s 851 of the *Corporations Law* (like Section 2 of Article III of the *NASD Rules of Fair Practice)* does not give rise to a duty of the broker to seek information from its client, but requires the broker to take reasonable steps to ensure that a recommendation made to its client is consistent with the information which the broker possesses about the financial position of the client and with the investment objectives and needs of the client.[193] However, in Release 352 (issued in April 1990) the National Companies & Securities Commission expressed the view that the broker's obligation to seek information as to the client's investment objectives, financial situation and particular needs would, in

189 RR Pennington, note 110 *supra*, pp 112-113.

190 *Hanly v SEC*, note 9 *supra*.

191 424 F Supp 1021, 1037 (SDNY 1977).

192 *Gochnaier v AG Edwards & Sons Inc* 810 F 2d 1042 at 1050 (11th Cir 1987); CR Goforth, note 71 *supra* at 437.

193 *Australian Corporation Law*, para [7.2.0065].

the case of a new client and in any other case where the adviser did not have sufficient information to make a reasonable recommendation, arise from the broker's duty of care and any fiduciary obligation owed by the adviser to its client. The NCSC suggested that, if a client was unwilling to give the adviser information which the adviser considered necessary to form a recommendation, the adviser would need to consider whether it could make a recommendation.

The American authorities suggest that the requirement that a broker have a reasonable basis for its recommendation extends to requiring that the broker seek to obtain information concerning its client's other security holdings, his or her financial situation, and his or her investment needs so as to be in a position to judge the suitability of a recommendation.[194] The American cases suggest that, in making a recommendation, the brokers must also take into account the risk profile which is suitable for the client's investment objectives.[195] There is American authority that a broker does not satisfy its duty to have a reasonable basis for its recommendation where it merely relies on information provided by the issuer of the security;[196] and that an individual representative of a broker does not necessarily have a reasonable basis for his or her recommendation if he or she relies on information provided by his or her employer without exercising an independent judgment as to that information.[197]

The extent of the research and analysis which is required to satisfy the broker's obligation to give such consideration to and conduct such investigation of the subject matter of a recommendation as is reasonable in all the circumstances will vary with the nature of the security, the circumstances in which the advice is given and the needs and expertise of the broker's client. For example, it would obviously be impossible for a broker to take into account the specific needs and circumstances of the recipients of a newsletter or circular which it makes available to clients having diverse characteristics. In these circumstances, NCSC Release 352 suggested that the newsletter or circular "should make clear [its] inherent limitations by indicating that it is not possible to take into account each client's individual circumstances and that clients should contact the adviser to make him aware of any particular needs before acting on a recommendation."

In NCSC Release 352, the NCSC indicated its view that the requirement that a securities adviser (which, in this context, would include a securities broker) must have a reasonable basis for its recommendations cannot be avoided through the use of exclusion clauses in contracts with clients. That Release went further to suggest that, where exclusion clauses in agreements with clients purport to limit, exclude or modify the client's right to reasonable advice, they

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194 L Loss, note 7 *supra*, p 832.

195 Mundheim, "Professional Responsibilities of Broker-Dealers: The Suitability Doctrine" (1965) *Duke LJ*, 445 at 449-450.

196 *Hanly v SEC*, note 9 *supra* at 597; RW Jennings and H Marsh, note 7 *supra* at p 630.

197 *Hanly v SEC*, *ibid* at 596; *Walker v SEC* 384 F 2d 344 at 345 (2d Circ 1967).

are unenforceable to the extent that they contradict the legislation and also "expose the adviser to legal challenge for making false or misleading statements which directly or by implication infringe upon investor rights." Notwithstanding the NCSC's comments, there may still be scope for an exclusion clause which, subject to a saving of statutory rights of the client, limits the liability of the adviser to clients. Such a clause may be effective to exclude or limit the existence of a duty of care in negligence. In some circumstances, an exclusion clause may also be effective to break the causal nexus between the advice and the client's reliance on that advice.

C. CIVIL LIABILITY FOR BREACH OF SUITABILITY OBLIGATIONS

A broker's failure to undertake an adequate investigation prior to making a recommendation, or the making of a recommendation which is unsuitable in the light of the client's needs and objectives, would obviously increase the risk that the trading decision made by its client will be unsuitable.[198] Section 852 has the effect that a broker which contravened s 851 by failing to have a reasonable basis for its recommendation is liable to compensate a client who relied on the recommendation, if that reliance was reasonable and the client suffered loss. Section 852(4) allows a defence against civil liability if the recommendation was appropriate in all the circumstances, although the broker had not conducted a reasonable investigation or given reasonable consideration to the recommendation. It is likely that this defence would generally be difficult to establish as a matter of evidence.

The imposition of civil liability on a broker which does not have a reasonable basis for its recommendation is consistent with the broker's duty to exercise reasonable care and skill. The imposition of civil liability may also be supported on grounds of economic efficiency. A client who seeks a broker's recommendation as to a securities transaction presumably wishes to utilise the broker's expertise to assist in identifying and acquiring securities which are suitable in the light of the client's objectives and his or her preferred level of investment risk. That objective is not met if a broker recommends securities which involve an excessive risk, if that risk could have been reduced by recommending different securities or by recommending diversification of the client's investments. If a client was unable to obtain compensation from the broker for loss suffered in consequence, he or she would tend to invest increased resources in investigating the recommendation made by the broker. The need for increased investigation of that recommendation would reduce the benefit to the client of reliance on the broker's expertise. The fact that compensation is available to a client who suffers loss as a result of relying on an inappropriate recommendation made by a broker reduces the need for

198 DC Langevoort, note 69 *supra* at 1280.

monitoring of such recommendations by the client, and thereby preserves the benefit of the broker-client relationship.[199]

Any increase in the risk profile of the client's investments as a result of a broker's recommendation to its client should be taken into account in assessing damages for a failure to have a reasonable basis for the recommendation. For example, an unsuitable recommendation may have the result that the client's investment has a higher risk level than was appropriate having regard to the client's investment objectives and financial circumstances. In that case, it is arguable that damages should be calculated by comparing the performance of the investments recommended to the client with the performance of investments having an appropriate level of risk in the light of the client's investment objectives and circumstances.[200] The amount of damages recovered by the client would then depend on the extent to which investments which would have been appropriate in the light of the client's investment objectives and financial circumstances would have produced a better result than the investments recommended by the broker.

VIII. LIABILITY OF BROKERS FOR THE CONDUCT OF THEIR REPRESENTATIVES

Part 7.3 Division 4 of the *Corporations Law* imposes civil liability upon brokers, as holders of dealers licences, for the conduct of their representatives in certain circumstances. Broadly speaking, if a securities representative is identified as acting for a particular broker, then that broker is made liable for the acts of the representative although those acts are outside the scope of the representative's authority. However, liability is not imposed on a broker for the conduct of a person who is not in fact a securities representative of that broker, even if that person holds himself or herself out to the public as being a representative of the broker. Section 821 of the *Corporations Law* invalidates any agreement purporting to exclude, restrict or otherwise affect the broker's liability for the conduct of a representative, and avoids any agreement for the broker to be indemnified for such a liability. Saving provisions allow contracts of indemnity insurance; an agreement providing for a defaulting representative to indemnify the broker for the broker's liability in connection with the acts of that representative; and an agreement between licensees who have given proper authorities to the one representative which provides for one licensee to indemnify the other licensee for its liability for the acts of the representative.

Paragraph 3 of Section 8 of the proposed ASX Code of Conduct would require member organisations to "take responsibility for the actions of their

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199 FH Easterbrook and DR Fischel, note 180 *supra* at 651.

200 *Ibid* at 611-650.

employees and take reasonable steps so that their conduct does not adversely effect the reputation of the Stockbroking Industry" (para 3). In one sense, brokers already take responsibility for the conduct of their employees since (as noted above) a broker is subject to civil liability for the conduct of a person who holds a proper authority issued by the broker. The manner in which a broker would go about taking "reasonable steps" to ensure that the conduct of its employees did not "adversely effect the reputation of the Stockbroking Industry" is less obvious, although such steps might include providing adequate supervision of employees and ensuring that such employees had appropriate knowledge of the duties imposed on dealer's and investment adviser's representatives at common law and under the *Corporations Law*. Paragraph 4 of Section 8 of the proposed ASX Code of Conduct would require brokers to "take reasonable steps to establish and maintain compliance procedures so that their Directors/Partners and employees have sufficient knowledge of broking practice, relevant legal requirements, the Principles, Code of Conduct and Business Rules to properly undertake their business..." That paragraph would also require a broker to ensure that a "central reference point" is provided to staff in relation to such matters. Presumably, that requirement would be satisfied by a broker nominating an employee or employees as having responsibility for compliance issues. Paragraph 6 of Section 8 of the proposed Code of Conduct would require that member organisations take all reasonable steps to ensure that their staff are suitable and honest; that they are properly trained in both the letter and the spirit of Rules; are adequately supervised to a level commensurate with their responsibilities; and are kept informed and updated of requirements and developments that relate to their duties.

To the extent that paragraphs 3, 4 and 6 of section 8 of the proposed ASX Code of Conduct would require a broker to supervise the conduct of its employees, they overlap with reg. 7.3.02(1) of the Corporations Regulations, which has the effect that a dealers licence is subject to a condition that the licence holder ensure that each representative is adequately supervised in the performance of duties he or she is required to perform by the licence holder. This provisions may be compared with s 15(b) of the *Securities Exchange Act* 1934 (US), which requires a broker to supervise its employees with a view to preventing violation of the securities laws. Under that section, a broker's failure to take reasonable steps to supervise its employees is a ground for suspension or revocation of registration of the broker, subject to a defence if the broker has established procedures for supervision which were carried out in the relevant circumstances.[201] Under American law, civil liability may also be imposed on a broker for a failure to establish and enforce a proper system of supervision

201 N M Brown, J McLaughlin, A B Levenson "Counselling Issuers Investment Bankers and Institutional Investors" in SJ Freidman et al (eds), *19th Annual Institute on Securities Regulation*, 1988, p 131.

and control over the operations of its employees and representatives,[202] either on the basis that the broker is treated as a "controlling person" in respect of the activities of its employee or representative or alternatively on the basis that the broker is subject to liability for conduct of its employees under common law agency principles.[203]

A. OTHER CIVIL LIABILITY UNDER THE CORPORATIONS LAW

The general civil liability provisions contained in the *Corporations Law*, particularly s 995 and s 1005, are also capable of imposing civil liability on brokers in relation to conduct undertaken in connection with dealings in securities. Section 995 is contravened by conduct that is misleading or deceptive or likely to mislead or deceive in connection with any dealing in securities. Section 995 is broadly similar to s 52 of the *Trade Practices Act* 1974 (Cth), which would also have applied to brokers' dealings in securities in appropriate circumstances.[204] Section 995 may give rise to liability where conduct is misleading in fact, even if that conduct is neither intentionally misleading nor negligent. Section 765 of the *Corporations Law*, which corresponds to s 51A of the *Trade Practices Act*, creates a presumption that a representation or prediction as to a future matter is misleading if a person does not have reasonable grounds for making the recommendation. If an action is brought against a broker in relation to such a representation or prediction, the broker would bear the onus of showing that it had reasonable grounds for the representation or prediction. Section 1005 permits a person to recover damages where he or she has suffered loss as a result of the conduct of another person who has contravened the provisions of the *Corporations Law* dealing with market misconduct or the prospectus provisions.

IX. EXCLUSION OF PERSONS FROM THE SECURITIES INDUSTRY[205]

Under the *Corporations Law*, the ASC has power to revoke a dealers licence held by a broker on certain grounds without allowing the broker an opportunity to be heard, and also has the power to revoke that licence in certain other circumstances after allowing the broker an opportunity to be heard. The grounds for revocation of a licence include the broker's contravention of a securities law (s 826(1)(c)); that the ASC has reason to believe that a natural person is not of good fame and character (s 826(1)(e)); the appointment of new

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202 *Del Porte v Shearson, Hamilton & Co Inc* 548 F 2d 1149 (5th Cir 1977).

203 *SEC v Management Dynamics Inc* 515 F 2d 801 (2f Cir 1975), in *Re Atlantic Financial Management Inc* 784 F 2d 29 (First Cir 1986).

204 *Milner v Delita Pty Ltd* (1985) 61 ALR 557.

205 See also *Australian Corporation Law*, paras [7.1.1525] and following.

officers or changes in the duties of existing officers of an incorporated broker (s 826(1)(f)(g)); and the suspension or revocation of a licence or the making of a banning order against a director, secretary or executive officer of an incorporated broker (s 826(1)(h)).

Section 824 authorises the ASC to revoke a licence held by a natural person without a hearing where the licensee becomes an "insolvent under administration", as defined in s 9; where the licensee is convicted of serious fraud, defined in s 9 as an offence involving fraud or dishonesty and punishable by imprisonment for a period of at least 3 months; the licensee becomes incapable, through mental or physical incapacity, of managing his or her affairs; or the licensee requests the ASC to revoke the licence. In the case of an incorporated broker, s 825 authorises the ASC to revoke a licence held by the broker without a hearing if it ceases to carry on business. The ASC is also entitled to revoke a licence of an incorporated broker without a hearing if it becomes externally administered, as defined in s 9. This power would be available if an incorporated broker was wound up; if a receiver or receiver and manager was appointed in respect of the property of the broker; if the broker was placed under official management; or if the broker entered a compromise or arrangement, the administration of which had not been concluded. The ASC may also revoke the licence of an incorporated broker without a hearing if a director, secretary or executive officer of that broker contravenes Chapter 7 of the *Corporations Law* because he or she does not hold a licence or because the licence which he or she holds is suspended.

Section 826 authorises the ASC to revoke the dealers licence of a broker on certain grounds provided that it has first allowed the broker the opportunity for a hearing. A licence held by a broker who is a natural person or an incorporated broker may be revoked after a hearing if the broker's application for the licence contained false or misleading information or omitted material information: s 826(1)(a)(b). A licence held by a broker who is a natural person or an incorporated broker may also be revoked after a hearing if the broker contravenes a securities law: s 826(1)(c). A failure of a broker to lodge an annual statement or to lodge accounts within the relevant time limits is treated as a contravention of a securities law falling within the scope of s 826(1)(c). The ASC may also revoke the dealers licence held by a broker if the broker contravenes a condition of the licence: s 826(1)(d). The power to revoke a licence for breach of a securities law corresponds to the power of the Securities and Exchange Commission to revoke a licence for contravention of the securities legislation under s 15(b)(4) of the *Securities Exchange Act* 1934 (US). The proper exercise of this power by the ASC would require it to consider whether the circumstances of a particular breach of the legislation are sufficiently serious to justify revocation of the licence, having regard to the principles established by *Story v NCSC*.[206]

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206 (1988) 13 ACLR 225, 6 ACLC 560.

The ASC may also revoke the licence of a broker who is a natural person after allowing the broker an opportunity to be heard if it has reason to believe that he or she is not of good fame and character: s 826(1)(e). In reaching that belief, the ASC may have regard to a matter that arose before the issue of the licence if it was not aware of that matter at the time the licence was granted: s 826(2). A licence of an incorporated broker may be revoked where persons become officers of the broker after the licence was granted or where the duties of officers of the broker change after the licence was granted, and the ASC is satisfied that the education or experience of an officer is inadequate having regard to the duties he or she performs in connection with holding the licence: s 826(1)(f) and s 826(1)(g). The ASC will presumably exercise this power to secure continuity in the standard of education and experience of officers of the corporation after a licence had been granted.[207] The licence of an incorporated broker may be revoked, after allowing it the opportunity to be heard, if a licence held by a director, secretary or executive officer of the broker is suspended or revoked or a banning order under s 830 is issued against a director, secretary or executive officer of the broker: s 826(1)(h).

The licence of an incorporated broker may also be revoked if the ASC has reason to believe that the broker has not performed the duties of the holder of a dealers licence efficiently, honestly and fairly, or will not perform those duties efficiently, honestly and fairly: s 826(1)(j) and s 826(1)(k). The criteria of efficiency, honesty and fairness adopted in s 826(1)(j) and s 826(1)(k) are equivalent to the criteria for grant of a licence to a natural person under s 783(2)(e) and to the criteria applied to each responsible officer of a corporate applicant for a dealer's licence under s 784(4)(d). In NCSC Release 333 (effective 1 July 1990), the NCSC stated that "[t]he obligation of licensees to perform their duties efficiently, honestly and fairly is a continuing one and, therefore, if the Commissioner has reason to believe that the licensee has not performed the duties of a licensee efficiently, honestly and fairly it may, subject to hearing submissions from the licensee, suspend or revoke the licence" (paragraph 4). The Commission referred to *Nisic and A'Hearne v Corporate Affairs Commission*[208] as authority that the Commission is entitled to draw inferences from the conduct of a business of a licensee other than a securities business in reaching a conclusion that the licensee has not conducted his securities business efficiently, honestly and fairly. The Commission noted that the manner in which a licensee conducts a business other than a securities business is more likely to be relevant where it is "intermingled with the securities business or is a related business", citing insurance broking as an example of such a related business (para 13).

The "efficiently, honestly and fairly" standard arguably reflects industry norms of conduct at a particular time, although it may be founded on an

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207 Note 2 *supra*, para [9.14].

208 (1990) 8 ACLC 514.

objective minimum standard corresponding to the standard of conduct which would be expected of a licensee by the reasonable client. The meaning of the terms "efficiently, honestly and fairly" was considered in *Story v NCSC*.[209] In that case, the appellant was a licensed dealer and was employed as a stockbroker. In attempting to interest a purchaser in shares in a mining company, he transmitted a study of the company to the prospective purchaser, which asserted that there was "another active bidder in the wings." In proceedings before the Sydney Stock Exchange, the appellant admitted that the reference to another bidder was inaccurate. After allowing the appellant a hearing, the NCSC revoked the appellant's dealers licence pursuant to s 60(1)(b) of the *Securities Industry Code*. The appellant sought review of that decision under s 537 of the *Companies Code*, and argued that the NCSC had erred in law as to his fitness to hold a licence. Young J observed that the court had to determine whether the appellant's performance of his functions fell short of the reasonable standard of performance by a dealer which the public is entitled to expect. His Honour held that a licensee "performs his duties efficiently if he is adequate in performance, produces the desired effect, is capable, competent and adequate."

In *RJ Elrington Nominees Pty Limited v Corporate Affairs Commission*,[210] the Court observed that conduct which is not honest may include conduct which is not criminal but which is morally wrong in a commercial sense, and that the test of whether conduct failed the relevant standard required that the conduct be viewed objectively. In that case, the Corporate Affairs Commission had revoked a dealers licence on the ground of breach of conditions attaching to the licence, including conditions as to net tangible asset requirements and as to the persons to whom investment advice in relation to securities could be given, and on the ground of conflict of interest arising where the dealer gave investment advice in relation to securities in an associated company. The Court held that an isolated breach of the net tangible assets condition and the dealer's failure to notify that breach did not merit revocation of the licence; however, conduct of the dealer in providing investment advice in respect of securities of an associated company put the dealer in a situation of a conflict of interest amounting to a breach of the licence conditions and a breach of the dealer's obligation to act "efficiently, honestly and fairly" under s 60(1)(b) of the *Securities Industry Act and Codes*. A breach of the requirement that a broker act "efficiently, honestly and fairly" might be established, for example, by conduct of a broker in breach of s 849, which requires it to disclose matters which may influence a recommendation to its client; or by conduct in contravention of s 851, which requires it to have reasonable grounds for a recommendation.

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209 Note 206 *supra*.

210 (1990) 1 ACSR 93.

The decision in *Story v NCSC*[211] indicates that there is no punitive element in the power to revoke a dealer's licence under s 826(1)(j), and that the power to revoke a licence must be exercised by the ASC with regard to the protection of the public interest. Young J held that it was necessary to weigh various matters in determining whether a dealers licence should be revoked on the basis of a finding that the dealer had not acted efficiently, honestly and fairly, including the public interest that qualified persons should be permitted to follow a profession; and on the other hand the public expectation that persons falling short of minimum standards will be removed from a profession, at least until the regulatory body is satisfied that they can efficiently perform their functions. His Honour noted that the decision to revoke a licence should only be made "if, for the public's protection, the dealer should not be permitted to trade". The approach adopted in *Story v NCSC*[212] is broadly consistent with the approach adopted under American law, which requires sanctions imposed upon a broker-dealer in disciplinary proceedings to be "in the public interest". Some American decisions have held that such sanctions may have a punitive or deterrent purpose.[213] However, in *Pierce v Securities and Exchange Commission*,[214] the Court characterised denial of registration of a broker-dealer not as a penalty but as a means of protecting the public interest. On the latter approach, the Court must have regard to the likelihood that a contravention will be repeated, the intention of the broker at the time the contravention took place and any evidence of contrition.[215] In *Blinder Robinson & Co v SEC*,[216] the Court held that "[t]he public interest standard is obviously very broad", and that the SEC's "broad discretion in fashioning sanctions in the public interest cannot be strictly cabined according to some mechanical formula".

Section 827 of the *Corporations Law* empowers the ASC to suspend a broker's dealers licence instead of revoking it on any of the grounds specified in s 824 and s 825, provided it has first allowed the broker an opportunity for a hearing. Section 827 would allow the ASC to suspend a broker's dealers licence where a licensee has breached the requirement that the licensee act efficiently, honestly and fairly. Section 827 also authorises the ASC to suspend a licence rather than revoke it for breach of financial conditions imposed under a licence.

Section 837(d) requires the ASC to allow a broker a hearing before it revokes or suspends a licence, other than in limited circumstances. The statutory requirement that the ASC afford a hearing to the licensee before revocation or suspension of a licence is consistent with the tendency in the cases to find that

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211 Note 206 *supra.*

212 *Id.*

213 *Steadman v SEC* 603 F 2d 1126 at 1140 (5th Cir 1979), aff'd 450 US 91 (1981); JD Cox, note 71 *supra*, p 1201.

214 239 F 2d 160 (9th Cir 1956).

215 JD Cox, note 71 *supra*, p 1201.

216 837 F 2d 1099 at 1110, 1113 (DC Cir 1988). See also L Loss, note 7 *supra* at 632.

the holder of a licence has a legitimate expectation at stake, such that the licensing authority would be obliged to afford procedural fairness and in some cases an opportunity for a hearing, if the licence was to be revoked.[217] The ASC is required to conduct any hearing into the conduct of a licensee with the aim of establishing the facts which will allow it to form a view, rather than conducting the hearing for the purpose of allowing the opportunity to the licensee to seek to dissuade it from a view which it had previously formed. In determining whether the matter alleged against the licensee has been established and whether the licence should be revoked, the ASC is obliged to consider and evaluate the whole of material obtained at the hearing together with material it has considered prior to calling the hearing.[218]

Section 828 of the *Corporations Law* authorises the ASC to issue an order banning a natural person from acting as the representative of a dealer or investment adviser if the licence of that person has been revoked or suspended on certain specified grounds.[219] The power to issue a banning order is intended to ensure that in those circumstances the person whose licence has been suspended cannot continue to act in the securities industry as a representative. Section 836 has the effect that a dealers licence or investment advisers licence may not be granted to a person if a banning order prohibits the person from acting as a dealers or investment advisers representative. Section 838 authorises the Court, on the application of the ASC, to make certain orders where the ASC has revoked the licence of a person or has made a permanent banning order against that person. Those orders include an order disqualifying the person from holding a dealers licence or investment advisers licence either permanently or for a specified period; prohibiting that person from doing an act as dealers representative or investment advisers representative either permanently or for a specified period; and such other order as the Court thinks fit. In determining whether to make an order under s 838, particularly an order in the nature of a permanent disqualification, it is likely that the Court would have regard to the factors identified in *Story v NCSC*.[220]

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217 *Salemi v MacKellar* (No 2) (1977) 131 CLR 396 per Barwick CJ at 405; *FAI Insurances Ltd v Winneke* (1982) 151 CLR 342; M Allars, "Fairness: Writ Large or Small" (1987) 11 *Syd LR* 306 at 314; *Australian Corporation Law*, para [7.1.1570].

218 See *Story v NCSC*, note 206 *supra*, where Young J held that the corresponding provision of the Securities Industry Code required that, prior to holding a hearing, the NCSC had formed a belief as to the matters which gave rise to the possibility that the licence would be revoked; that there must be reasonable grounds for that belief in fact; and that the NCSC was of the view that revocation of the licence would be seriously considered were its view of the facts to remain unchanged after the hearing. See also *Nam Bee (Aust) Pty Ltd v CAC* (1987) 12 ACLR 391, 6 ACLC 79.

219 *Australian Corporation Law and Practice*, para [7.1.1565].

220 Note 206 *supra*.

A. POWERS OF SUSPENSION AND EXPULSION UNDER THE ASX ARTICLES OF ASSOCIATION

Article 51 of the *ASX Articles of Association* confers certain powers on the ASX Board where a member or member organisation is found guilty of infringing the Articles or Business Rules of ASX, including powers of censure, fining and suspension for a period not exceeding 3 months. Under Article 51(2), a member or member organisation is deemed liable for breach of the Articles or Business Rules by a partner, officer, employee or consultant. Article 52 empowers the ASX Board to charge a member with prohibited conduct, being conduct which is not efficient, honest or fair or is otherwise prejudicial to the interest of the exchange or its members. By contrast with s 783(2)(e), s 784(4)(d) and s 826(1)(j) of the *Corporations Law*, Article 52 of the ASX Articles of Association uses the words efficient, honest or fair disjunctively. Nonetheless, its seems that the proper reading of Article 52 is to treat the criteria of efficiency, honesty or fairness as operating together, and to determine whether a broker fails to satisfy any one requirement with regard to his obligation to satisfy the other requirements. The decision in *Story v NCSC*,[221] discussed above, suggests that the words "efficiently, honestly and fairly" must "be read as a compendious indication meaning a person who goes about their duties efficiently having regard to the dictates of honesty and fairness, honestly having regard to the dictates of efficiency and fairness, and fairly having regard to the dictates of efficiency and honesty". It is clear that in some circumstances compliance with Article 52 would require a broker to sacrifice efficiency to the requirements of honesty or fairness. It is less likely that a broker could justify a failure to act honestly or fairly for the purposes of Article 52 on the ground that the Article requires that it act efficiently. The better view is that the requirement to act efficiently for the purposes of Article 52 should be read as a requirement that the broker act as efficiently as possible while conducting his business in an honest and fair manner.

If the ASX Board charges a member with prohibited conduct under Article 52, it must give the member not less than 7 days written notice of the particulars of the charge and the date upon which the charge is to be heard, and must allow the member an opportunity to be heard in answer to the charge. Article 52(2) provides that the penalties which the Board may impose for prohibited conduct are censure of the member or member organisation or a fine not exceeding $25,000; and/or suspension of the member and/or prohibiting the member transacting business with or through a member organisation for a period up to 3 months; or expulsion from membership of the Exchange of the member or of a partner, officer or employee of a member organisation. In addition to imposing a penalty under Article 52(2), under Article 53(2) the ASX Board may require the member or member organisation to pay the total or part of the commission

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221 *Id.*

or profit arising from the transaction to the Exchange, and the whole or part of the reasonable costs incurred by the Exchange in hearing the matter.

At common law, the power of the Exchange to discipline or expel its member must be exercised fairly and in good faith. Exercise of the power is subject to judicial review if it fails to satisfy those obligations. The onus of showing lack of good faith in proceedings for review of a decision of the Exchange rests on the party alleging it.[222] It is clear that the ASX Board is required to reach its decision having regard to the evidence, and that its decision would be invalid if the evidence supporting it was so slight that no reasonable tribunal could have reached the decision. On the other hand, the ASX Board as a domestic tribunal may be entitled to reach a finding on evidence which would not be sufficient to support that finding in court proceedings. In proceedings for judicial review, it is likely that such a finding would only be set aside if the court found it to involve a high degree of unreasonableness. Given the seriousness of a charge of prohibited conduct, it appears that the standard or proof required to establish that charge in proceedings before the ASX Board will be higher than the civil standard of the balance of probabilities, but lower than the criminal standard of proof beyond reasonable doubt. The appropriate standard may require the ASX Board to be satisfied on the evidence that the broker has engaged in prohibited conduct to the "comfortable or confident satisfaction of the tribunal".[223] The powers of the Exchange also have to be exercised with regard to the obligations of procedural fairness. The obligations of procedural fairness will be more demanding where a substantial interest of a member of the Exchange, being his or her ability to conduct his or her business, is under threat.[224]

B. RIGHTS OF APPEAL FROM DISCIPLINARY DECISIONS OF ASX

Article 54 of the *ASX Articles of Association* allows a member to appeal to the ASX Board from a finding of guilty and consequent censure, fining, suspension or expulsion under Article 52, where the decision is made by a delegate of the ASX Board. The appeal lies to an Appeal Committee from a decision made by the ASX Board. An appeal under Article 54 is conducted by a review of the findings reached in the decision under appeal rather than by re-hearing.

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222 *Weinberger v Inglis* [1919] AC 606; R Baxt, note 5 supra, p 74.

223 JRS Forbes, *The Law of Domestic or Private Tribunals* (1982) p 140.

224 As to the obligations of procedural fairness where existing rights are in issue, *Dunlop v Woollahra Municipal Council* [1975] 2 NSWLR 446; *McNab v Auburn Soccer Sports Club Ltd* [1975] 1 NSWLR 54 at 59, where Needham J held that a member of a club threatened with expulsion for breach of its rules was entitled to natural justice where the rules of the club permitted him to attend a meeting at which his expulsion was to be considered, but that in the circumstances natural justice did not require that he be allowed a right of legal representation; *Posluns v Toronto Stock Exchange* (1964) 67 DLR (2d) 165.

At common law, the courts would be unlikely to intervene in a decision of the ASX Board or its delegate or the appropriate internal appellate body if that decision was characterised as a decision of a domestic tribunal, except if breach of procedural fairness was established. The courts may be more willing to allow substantive review of a decision of ASX in relation to discipline of its members if that decision can be characterised as made in the exercise of a public function rather than as deriving from the contractual relationship between ASX and its members. It may be that ASX is not properly characterised as a purely domestic and non-statutory body, having regard to s 769 of the *Corporations Law* as to approval of a stock exchange by the Ministerial Council; to s 774 as to notification of amendments of the rules of a stock exchange; and to s 1114 which allows the Court to make orders in the event of a contravention of the *ASX Business Rules*. If the Court has jurisdiction at common law to review a decision of ASX made in the exercise of its disciplinary powers over brokers, the grounds on which such a decision could be challenged would include that the decision took into account irrelevant considerations, that it failed to take into account relevant considerations, or that it was an unreasonable exercise of power.[225]

C. DECLARATIONS OF DEFAULT

Article 60(1) of the *ASX Articles of Association* authorises the ASX Board to intervene in the business of a member if the ASX Board is of the opinion that the member has failed or is unable to fulfil its engagements; if the member fails to act in accordance with Article 48 and Article 49 in relation to investigations; the member is proved to the satisfaction of the Board to be insolvent; or the member is a partner in a member organisation which is a defaulter under Article 60(2). Article 60(2) provides similar powers in respect of member organisations if, in the opinion of the ASX Board, the member organisation has failed or is unable to fulfil its engagements; the member organisation is proved to the satisfaction of the Board to be insolvent; or a shareholder or partner in the member organisation is a defaulter under Article 60(1). If the ASX Board declares a member to be a defaulter under Article 60, the member ceases to be a member. If the ASX Board declares a member organisation to be a defaulter, the member organisation ceases to be entitled to carry on business as a member organisation. Article 60(4) empowers the Board to appoint a registered liquidator as receiver or receiver and manager of a member or member

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225 *R v Panel on Takeovers and Mergers; Ex parte Datafin plc* [1987] 1 QB 815; *R v Takeover Panel; Ex parte Guiness plc* [1989] 2 All ER 509; AJ Black, "Judicial Review of Discretionary Decisions of Australian Stock Exchange Limited" (1989) 5 *Australian Bar Review* 91; D Brewster "Judicial Enforcement of the Listing Rules of Australian Stock Exchange" (1991) 9 *C&SLJ* 313; D Brewster, "Decisions under the Australian Stock Exchange Listing Rules: Review under the Administrative Decisions (Judicial Review) Act" (1991) 9 *C&SLJ* 337; *Australian Corporation Law*, para [7.1.0455.]

organisation's business after it has declared the member or member organisation to be a defaulter under Article 60. The *ASX Articles of Association* provide no means of appeal against a declaration of default under Article 60 and a consequent cessation of membership of the Exchange.

X. CONCLUSION

This article has considered a number of aspects of the professional responsibilities of brokers and their exposure to liability. It was noted that investors depend upon securities professionals for the quality of advice given; for the absence of bias in advice and for the resolution of conflicts of interest in favour of the investor; for custody of investor property; and for the absence of fraud and unacceptable practices by the dealer or investment adviser. The application of regulatory controls to brokers, and the imposition of civil liability upon brokers at common law and by statute, can be supported on grounds which include the need to ensure that brokers act to promote a fair and orderly market, in order to maintain investor confidence in the securities markets.

A broker is subject to obligations imposed at common law, including a duty to use reasonable care and skill in carrying out its client's instructions and a duty to make the best possible bargain for its client within the limits set by those instructions. At common law, a broker may be under further duties to make a valid and enforceable contract; to act honestly and to observe the rules, usages and market practices of the Exchange; to keep its clients' property separate from its own property; and to keep proper accounts to enable its clients' property to be recorded accurately. If a broker acts in accordance with its client's instructions and its legal obligations, it is entitled at common law to be indemnified by its client for liability arising out of the transaction. This right of indemnity is confirmed by the *ASX Business Rules*, which allow the broker to resell securities purchased on behalf of a buying client if the client defaults in payment, and to buy in securities to satisfy its delivery obligations at the client's cost if the client fails to deliver scrip sold on the client's behalf. At common law, a broker which fails to act in accordance with its client's instructions may lose its right to commission and lose the right to an indemnity from its client.

At common law, the rules of the relevant stock exchange are incorporated by reference in contracts between clients and brokers. There is authority that, where a client instructs his broker to buy or sell securities on a stock exchange, it is an implied term of the agency contract between client and broker that the client will be bound by the business rules of the exchange to the extent that they establish the manner in which a contract for the sale and purchase of securities is formed upon the Exchange and the incidents of such a contract. Conversely, it appears that the broker is under a contractual obligation to its client to comply with the rules and regulations of the Exchange in relation to the purchase or sale of securities.

A broker may be held liable for loss suffered by its client under the law of negligence. A relationship of proximity between the broker and its client with respect to foreseeable economic loss will be established by the assumption of responsibility by the broker, combined with the client's reliance on the broker's exercise of its professional skills and the forseeability of economic loss to the client if the broker fails to exercise due care and skill. The broker's duty to exercise reasonable care and skill owed to the client in tort is reinforced by s74 of the *Trade Practices Act* 1974 (Cth), which implies a term in contracts for the supply of services to a consumer that the services will be rendered with due care and skill.

A broker which is instructed to buy and sell shares acts as agent for its client, and is under a fiduciary obligation to avoid situations of conflict between its interests and those of its client, and not to compete with its client in trading on its own account. It was noted that it may be appropriate to distinguish between the role of securities brokers and that of agents generally, since a broker trades in a competitive market where the price of the commodity is set by a large number of individual trades and where the broker has limited ability to influence that price by negotiation with the other party to the transaction. Notwithstanding that distinction between the traditional function of an agent and that of a securities broker, it was argued that the relationship between broker and client is characterised by features which support the imposition of fiduciary duties, including the entrusting to the broker of the power to affect the interests of its client and the broker's undertaking to act in its client's interests within the scope of its contract with its client. It may be that the scope of a broker's fiduciary obligations would be narrowed in circumstances that the client does not rely upon the broker for advice, and the broker merely executes transactions on the client's instructions.

It was noted that Rule 5.7 of the *ASX Business Rules* imposes personal liability on brokers in dealings with each other on the Exchange. This Rule reflects the usage of the Exchange, by which a broker dealing with another member does not reveal the identity of its client. There is some support for the further proposition that a broker accepts personal liability to his or her client; although it seems that, on the authority of *FAI Traders Insurance Company Ltd v ANZ McCaughan Securities Ltd*,[226] such a usage may not extend to special crossings. It was noted that the National Guarantee Fund guarantees the obligations of payment or of the provision of settlement documents in respect of trades undertaken by members of the Exchange. The Fund is available to meet claims against insolvent brokers where property was entrusted to the broker, although no claim is available to a person who is merely a creditor of the insolvent broker in relation to money lent to the broker.

The professional responsibilities of securities brokers are substantially affected by legislative intervention, including the licensing of dealers and

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226 Note 23 *supra*.

investment advisers. The *ASX Business Rules* also deal with a number of aspects of the conduct of the business of securities brokers. Part 7.3 of the *Corporations Law* imposes financial requirements and requirements as to conduct of business upon securities brokers, by virtue of their status as licensed dealers. Section 3 of the *ASX Business Rules* imposes further obligations upon brokers in their dealings with clients, including obligations of disclosure when the broker trades as a principal and of disclosure of allocation policy; obligations as to settlement with clients; and obligations as to the issue of contract notes. Section 3 of the Business Rules seeks to reduce the risk that a broker which has an element of discretion in its dealings with its client might breach its fiduciary obligations to his client and prefer its own trading interests to that of the client; might advise the client to undertake an excessive number of transactions in order to increase its receipts from commission; or might misappropriate funds or securities held on behalf of its client.

For example, Rule 3.4.2 of the *ASX Business Rules* deals with the practice of 'churning'. While a broker's conduct would not breach Rule 3.4.2 if the broker does not operate a discretionary account or managed fund on the client's behalf, circumstances involving 'churning' of a non-discretionary account are likely to constitute a breach of the broker's fiduciary duty to its client. Section 843 of the *Corporations Law* (which substantially coincides with Rule 3.1(2) of the *ASX Business Rules*) prohibits a broker from dealing in securities on its own account with a person who is not a licensed dealer, unless the broker first informs that person that the dealer is acting in the transaction as principal and not as agent. Even if a broker discloses to its client that it is acting as principal in the transaction, the reasoning of Brennan J in *Daly v The Sydney Stock Exchange Ltd*[227] suggests the broker may continue to be bound by a duty to obtain the best bargain for its client which the client would obtain from a third party, if the broker was to exercise due diligence on behalf of the client in the transaction with the third party.

Section 844 of the *Corporations Law* provides that, subject to certain exceptions, a dealer may not enter a transaction of securities traded on a stock market of a securities exchange if a client who is not an associate of the dealer has instructed the dealer to buy or sell securities of the same class and that transaction has not been completed. That section is a statutory recognition of a broker's duty at general law not to compete with his client. Section 849 requires a broker to disclose matters which may influence a recommendation to a client, while s 851 requires a securities broker to have reasonable grounds for a recommendation. Section 852 has the effect that a broker which contravenes s 851 by failing to have a reasonable basis for its recommendation is liable to compensate a client who relied on the recommendation, if that reliance was reasonable and the client suffers loss. The imposition of civil liability on a broker for breach of the requirement that it have a reasonable basis for its

227 Note 58 *supra*.

recommendation may be supported on grounds of economic efficiency, as avoiding the need for clients to invest increased resources in monitoring and investigating the recommendations made by brokers.

Part 7.3 Division 4 of the Corporations Law imposes civil liability upon brokers, as holders of dealers licences, for the conduct of their representatives in certain circumstances. Broadly speaking, where a securities representative is identified as acting for a particular broker, then that broker is made liable for the acts of the representative although those acts are outside the scope of the representative's authority. The general civil liability provisions contained in the *Corporations Law*, particularly s 995 and s 1005, are also capable of imposing civil liability on brokers in relation to conduct undertaken in dealing in securities.

The ASC has power to revoke the dealers licence held by a broker on certain grounds. The licence of an incorporated broker may be revoked under s 826 of the *Corporations Law* if the ASC has reason to believe that the broker has not performed the duties of the holder of a dealers licence efficiently, honestly and fairly, or will not perform the duties of a licensee efficiently, honestly and fairly. The decision in *Story v NCSC*[228] indicates that there is no punitive element in the power to revoke a dealer's licence, which must be exercised by the ASC with regard to the protection of the public interest. Under s 827 and s 828, the ASC is empowered to suspend a broker's dealers licence instead of revoking it, in appropriate circumstances, and to issue an order banning a natural person from acting as the representative of a dealer where the licence of that person has been revoked or suspended on certain specified grounds. Section 838 of the *Corporations Law* authorises the Court, on the application of the ASC, to make certain orders where the ASC has revoked the licence of a person or has made a permanent banning order against that person.

Article 52 empowers the ASX Board to charge a member with prohibited conduct, being conduct which is not efficient, honest or fair or is otherwise prejudicial to the interest of the exchange or its members. It seems that the proper reading of Article 52 is to treat the criteria of efficiency, honesty or fairness as operating together, and to determine whether a broker fails to satisfy any one requirement with regard to his obligation to satisfy the other requirements. At common law, the power of the Exchange to discipline or expel its member must be exercised fairly and in good faith. The powers of the Exchange also have to be exercised with regard to the obligations of procedural fairness, which will be more demanding where the ability of a member to conduct its business is under threat. It was noted that the courts would be unlikely to intervene in a decision of the ASX Board or its delegate or the appropriate internal appellate body if that decision was characterised as a decision of a domestic tribunal, except if breach of procedural fairness was

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228 Note 206 *supra*.

established. However, the courts may be more willing to allow substantive review of a decision of ASX in relation to discipline of its members if that decision can be characterised as made in the exercise of a public function rather than as deriving from the contractual relationship of the Exchange and its members.