SOME ASPECTS OF THE STOCK EXCHANGE: ITS NATURE AND FUNCTIONS
PART II

This is the second part of a two-part article on the Stock Exchange in New Zealand. In the first part, the nature and function of the Stock Exchange was explored. This Part more closely examines the relationship of broker and client and proposes reforms in the regulation of the stock brokering industry.

I. THE RELATIONSHIP OF BROKER AND CLIENT

The agency relationship between broker and client is the concept to which the lawyer always returns in resolving a dispute between them.

As an agent, the broker is in the position of a fiduciary to his client and he must be careful not to allow his duty and interest to conflict. The classic case of *Parker* v. *McKenna*[1] clearly expresses the general principles of fiduciary duties:

> No man can, in this court, acting as an agent, be allowed to put himself into a position in which his interest and his duty will be in conflict. The court will not inquire, and is not in a position to ascertain, whether the bank has lost or has not lost by the acts of its directors. All that the court has to do is to examine whether a profit has been made by an agent, without the knowledge of his principal in the course and execution of his agency, and the court finds, in my opinion, that these agents in the course of their agency have made a profit, and for that profit they must, in my opinion, account to their principal.[2]

(a) Broker Acting as Principal

Consequently, a broker cannot act as a principal to his clients unless he fully *discloses* that he is so acting. This applies, no matter how well meaning and unimpeachable the broker's action are. A good example of this is *Rothschild* v. *Brookman*[3] where a broker so framed a letter to his client as to lead him to believe that the sale and purchase

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1. (1874) L.R. 10, Ch. App. 96, 118; Note also *Regal (Hastings) Ltd.* v. *Gulliver* [1942] 1 All E.R. 378 and *Boardman* v. *Phipps* [1966] All E.R. 720.
2. Ibid., 453.
3. (1831) 5 Bli. New Reports 165. See also *Armstrong* v. *Jackson* [1917] 2 K.B. 822, 824.

of certain bonds had been made to third persons and on the most advantageous terms whereas in reality the broker had taken the bonds himself, not buying other bonds as instructed by the client but supplying them out of his own stock at a profit to himself.

However, where complete *disclosure* is made to a client that the broker is dealing with the client as a principal then the transaction will not be set aside by the court.[4]

(b) Commission

The broker is an agent and can charge only his commission. Rules 85 to 95 of the Stock Exchange Association of New Zealand Rules provide for a scale of commissions which *shall* be charged except in certain specified circumstances. The broker is not permitted to make a secret profit, nor can he add something to the price, besides charging commission. In *Stange & Co.* v. *Lowitz*[5] the stockbrokers not only charged their commission but also added an over-charge onto the price at which the shares were bought. The brokers conceded they were not entitled to the added charge but argued that they were entitled to an indemnity from their client for the balance. The Court held that the client could repudiate the whole transaction because the brokers could not show that they had effected the purchase of shares on behalf of the client as an agent. The brokers had purchased the shares as principals and resold them to the client.

(c) Secret Commissions

It should also be noted that the broker is subject to the Secret Commissions Act 1908, under s. 5 of which a duty is cast upon an agent to disclose any pecuniary interest which the agent has in the making of the contract. The agent must disclose this interest at the time of making the contract or as soon as possible thereafter. Not only may a transaction be rescinded but also under s. 13 the broker is subject to the penalties of imprisonment or fine. The Act appears never to have been used in connection with a stockbroker, apparently because the rules and practices of the Stock Exchange effectively govern and control the actions of stockbrokers. The broker is acting in a fiduciary capacity for his client and therefore must account to the client for any secret profit made.[6] In *Erskin Oxenford and Co.* v. *Sachs*[7] stockbrokers purchased shares on behalf of a client and on his failing to provide funds for payment, the brokers sold an equivalent

4. See *Ellis & Co. Trustees* v. *Watsham* (1923) 55 L.T.J.O. 363 where the words "bought of ourselves as principals" appeared on the two contract notes and the court refused to set aside the transactions.
5. (1898) 14 T.L.R. 4 and 8.
6. See e.g. *Stubbs* v. *Collett & Sons Limited* (1926) 21 MCR 104 where an agent who purchased an article from his principal, knowing that a third party would purchase the article for a higher price was obliged to give up his secret profit and commission after selling the article to the third party who thought he was buying from the principal.
7. [1961] 2 Q.B. 504.

amount on the market and as part of one transaction, repurchased the shares on their own account. By doing this, the brokers made a profit by purchasing the shares at a lower price than if they had merely purchased them in the market in the normal manner. The Court of Appeal held that the brokers, as fiduciaries, must account for the profit made to the client.

The customs of the Stock Exchange must be considered, especially with reference to *Keesing & Wright* v. *Eccles*[8] where the validity of the custom of certain members of the stock exchange was questioned. They included in the price of shares bought for future delivery a sum for the commission *and* charged this sum to their principals as part of the price paid for the shares. Edwards J. held that the custom was unreasonable and illegal and consequently not binding on the principal, relying on *Neilson* v. *James*.[9] The decision would appear to be supportable in terms of policy as it prevents a broker obtaining a commission by adding an amount on to the figure quoted in the advice-note to the principal as being the purchase price of the shares. The only situation where the learned Judge considered such a practice to be binding would be where there was express agreement between the broker and client that the broker could so do.

(d) Lumping of Orders

Lumping of orders takes place where a broker receiving orders from several clients to buy shares or stock in a certain company or security, goes into the market and purchases the total of the orders of the clients and allocates that total in his books to his buying clients. The problem with such a practice is that it can be said that the order purchased by the broker is not the same as the order he was instructed to fulfil for each client and therefore the broker is acting outside the terms of his agency. This issue arose in *Keesing & Wright* v. *Eccles*[10] where the defendant principal contended that a purchase in the name of the stockbroker of a larger number of shares than is authorised by the principal and the subsequent allocation to the principal in the books of such broker of the number of shares authorised by him was not within the *authority* of the broker.

Edwards J. dealt with the case in terms of the Stamp Duties Act 1902 but he also considered the English cases in obiter dicta. The stockbroker must act within the scope of his authority and if the purchase and the contract made are not the purchase and contract which the client authorised then the client is not bound.[11] However, in *Scott* v. *Horton & Godfrey*[12] it was held that a purchasing broker

8. (1906) 25 N.Z.L.R. 914.
9. 9 Q.B.D. 546. See also *Devonald* v. *Rosser & Sons* [1906] 2 K.B. 728, 743 and *Fulwood* v. *Hurley* [1928] 1 K.B. 498, 504.
10. (1906) 25 N.Z.L.R. 914.
11. See *May* v. *Angoli* 13 T.L.R. 568; *Callum* v. *Hodges* 17 T.L.R. 21; *Beckhuson & Gibbs* v. *Hamblett* [1900] 2 Q.B. 18.
12. [1901] 2 K.B. 726, 733.

instructed by each of several principals, strangers to each other, to purchase shares on their account can make one purchase on behalf of all his principals where there is a *custom* of the stock exchange that the selling broker appreciates that the purchasing broker *may* be acting for more than one client and hence the selling broker intends to make separate contracts with every client for whom the purchasing broker acts. Even if such usage were not found, it was held that so long as it was the intention of the brokers concerned that separate contracts for each client concerned were to be formed then there would be the requisite privity of contract.

This decision can be contrasted with *Beckhuson & Gibbs* v. *Hamblett*[13] where no such usage was established and the appeal failed. Edwards J.[14] thought that this inferred that the Court of Appeal considered that apart from such a usage there could be no privity of contract in such circumstances but in that case the point was abandoned by counsel and accordingly the statements of the Lords Justices were obiter.

The decision in *Keesing & Wright* v. *Eccles* left open the question whether apart from the provisions of the Stamp Duties Act 1902 the broker so acting would be within the scope of his authority. The writer is of the opinion that the arguments and decision in *Scott* v. *Horten & Godfrey* are forceful and practical. If a custom of lumping orders is established or if the brokers concerned both intend that to be the arrangement there would appear to be sufficient privity of contract to bind the principal. In contrast the English case of *Maffett* v. *Stewart*[15] should be noted where a purchasing broker purchased large amounts of stock at varying prices and allocated them to his ordering clients, charging a price calculated by averaging the varying purchase prices of the lots making the total "lump" of stock. The Court of Session could not find any parallel between that which was bought by the broker and that which was allocated to the client. The broker was acting outside the scope of his authority and could not bind his principal.

(e) Marriages of Shares

An issue associated with the lumping of orders arises where the broker, while acting for both buying and selling clients, "marries" their respective orders together to finalise a transaction off the floor of the exchange. In *Jones* v. *Canavan*[16] a firm of stockbrokers "married" the selling order of one client with a buying order of another. Canavan, the buying client who was being sued by the brokers to recover the price of the shares, argued that there was no practice, usage or custom applicable in the present case whereby the plaintiffs were authorised and permitted to "marry" the sale, and that if there were, such a

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13. See n. 14.
14. Note 10 at 925.
15. (1887) Court of Session 506.
16. [1972] N.S.W.L.R. 236.

practice it was unreasonable. The Court held that the general principle was applicable in that an agent,[17]

> may not act for both parties to a transaction unless he ensures that he fully discloses the material facts to both parties and obtains their informed consent to his so acting.

However, if there be a custom which is proved to be notorious, certain and reasonable then,

> a person who deals in a market is bound to inquire what its usages are, and that those who deal with him have the right to hold him bound by them to the same extent as a person would have been bound who belonged to the place. A person who directs another to make a contract at a particular place must be taken as having intended that the contract should be made in accordance with the usage of that place.[18]

Therefore, it was necessary for the Court to establish the three elements of: notoriety, certainty and reasonableness in ascertaining whether such a custom or usage existed. The test for *notoriety* was[19]

> If a usage . . . has become so general and notorious within its particular sphere that all persons dealing within its sphere can easily ascertain it, then those persons are presumed to have been aware of it when they entered into the contract and will be deemed to have submitted to be bound by it, although they allege that they were ignorant of its existence.

Whether or not a custom or usage had been proved with sufficient *certainty* depended on the degree of particularity with which it was sought to define the custom or usage.[20] The Court held there was a custom or usage established where there was a market from which the price at which the transaction could take place could be ascertained.

With regard to the element of *reasonableness* the Court held that the general principle that an agent cannot act for both parties to a transaction, can be distinguished in the instant case because;[21]

> The custom or usage of marrying transactions in the same brokers office is not unreasonable where the marrying or crossing of transactions does not result in any realistic way in a conflict of duty and interest. The limited function of the stock and sharebroker makes him an intermediary rather than a negotiating agent . . . There is no reason, therefore, why the apparently universal custom and usage of stock and sharebrokers on the marrying or crossing of orders should not be recognised by the Courts and regarded as reasonable.

17. See also *Fullwood* v. *Hurley* [1928] 1 K.B. 498, 502, per Lord Hanworth MR: "If and so long as the agent is the agent of one party, he cannot engage to become the agent of another principal without the leave of the first principal with whom he has originally established his agency."
18. 11 Halsbury's Laws of England (3rd ed.), 197
19. Idem.
20. [1972] 2 N.S.W.L.R. at 243.
21. Per Jacobs, J. A., ibid., 245.

The lumping of orders was therefore a permissible and enforceable method of effecting a transaction. Note should also be taken of r. 83 Stock Exchange Association of New Zealand Rules.[22]

II. BREACH OF CONTRACT

As has been stated,[23] "a stock exchange bargain can involve four contracts:

(i) the contract of the members inter se;

(ii) the buyer's contract to indemnify the member acting on his behalf

(iii) the seller's contract to accept the securities purchased by the member acting for him; and

(iv) the contract between the buyer and the seller."

Fisher v. *Park*[24] illustrates these contracts. There was a claim by the plaintiff, an agent and broker against his principal for indemnity for money paid in carrying out his instructions. The defendant broker instructed the plaintiff to buy certain shares, which the plaintiff did, forwarding a broker's note showing him buying "by order and on account" of the defendant. There was a broker's usage when the buying broker discloses his principal, for the seller to treat with such principal direct, the broker dropping out, but with a remedy against him in the case of the principal failing to comply. The plaintiff informed the defendant that the seller was demanding the buyer's name. Defendant told the plaintiff that the buyer's name was Hull but concealed the fact that Hull had earlier repudiated the contract. Had the plaintiff known of the repudiation, he would have treated the defendant as the principal and acted as defendant's agent in forwarding the shares and transfer to Hull. Instead he treated Hull as a bona fide buyer; when Hull refused the shares, there was no person prepared to take them and the plaintiff was relegated to his original position with the defendant. The plaintiff had become liable to his principal, Fenwick and had properly paid him outside being entitled to recover from the defendant as he had done nothing not within the principal's instructions. Accordingly judgment was for the plaintiff. Denniston J. noted that the defendant had his remedy against Hull whose liability was complete on his repudiation, the defendant having a right and duty to sell the shares to fix the measure of damages between himself and Hull because of the fall in the value of the shares between the time of sale and the time of repudiation. The transaction can be split up into the following contractual relationships:

(i) The contract between purchasing broker and selling broker for the selling broker to act as agent in buying some shares from someone, the transfer to be completed (as was the broker's practice) in the names

22. At p. 3.
23. Cooper & Cridlam, *Law and Procedures of the Stock Exchange*, 241.
24. (1895) 13 N.Z.L.R. 682.

of the principals when the purchasing broker supplied his principal's name. This contract was breached by the purchasing broker wrongly repudiating it and accordingly the selling broker was indemnified for any loss from him.

(ii) The contract between the selling broker and seller, whereby the seller was to be paid the bargained price for his shares: the broker duly completed this contract as a principal, paying the consideration agreed upon to the seller. The broker could then try and sell the shares for whatever he could get and recover the balance of his outlay from the purchasing broker under contract (i) above.

(iii) The contract between the purchasing broker and purchaser: although the purchasing broker was liable under contract (i) above, he was entitled to recover from the purchaser as it was the purchaser who wrongly repudiated his contract with both the purchasing broker and seller under the ultimate contract (iv) below.

(iv) The contract between purchaser and seller: the purchaser earlier repudiated his contract with his broker and when the selling broker tendered the transfer he refused to complete his contract with the seller on the grounds of his earlier repudiation. However it was unnecessary for the seller to seek recovery direct from the purchaser as each party to the transaction made good the loss to his principal or fellow-broker, claiming indemnity from the person next down the chain of liability until it stopped at the last link, the purchaser.

The operation of rr. 100 and 118 relating respectively to stockbrokers treating to each other as principals, and the default of a seller and subsequent buying procedure is described in *Sligo* v. *Oswin*[25] where the defendant authorised the plaintiffs, who were stockbrokers, to sell certain mining shares, knowing that the shares would be sold on the stock exchange. Accordingly the principle as enunciated in *Harker* v. *Edwards*[26] applied that

> when the defendant authorised the plaintiffs to make the contract on the stock exchange he authorised them to make themselves personally liable and to fulfil the contract according to those rules. If the defendant, being the vendor of shares refuses to carry out a contract which he had instructed his brokers to make, then the brokers must obtain the shares from elsewhere in order to fulfil the contract. An authority is implied from the vendor to the broker to purchase the shares in order to fulfil the contract. As where a broker is employed to buy shares he is authorised to carry out the contract by paying the price and recovering from his principal; so too, where a vendor does not make available the shares.

The brokers had rendered themselves liable under the rules of the exchange and that justified them in going into the market and purchasing the shares to enable them to fulfil the contract. Thereafter the

25. (1904) 23 N.Z.L.R. 337.
26. 57 L.JQB. 147, 148

brokers could require the vendor to indemnify them as the purchase was necessitated by the vendor's default of a valid contract. The converse situation occurred in *Utz* v. *Javor*[27] where the question of indemnity arose on failure of a client to purchase shares bought by a stockbroker on instructions. A firm of stockbrokers were instructed to sell certain shares. Before the time of delivery arrived the stockbrokers found out that the client did not own the shares and they purchased sufficient shares to cover the sale. However, the shares then dropped in value and trading was suspended. The stockbrokers succeeded on a claim based on the common law right of indemnity and on a right to repurchase under the rules with the seller liable for the cost. On appeal, the decision was reversed as the time for delivery had not arrived and the stockbrokers had acted prematurely in buying the shares in anticipation of a breach by the seller in failing to deliver them.

The case does show the tight-rope the broker must walk in his everyday dealings. As he is deemed a principal to other brokers, he is personally liable to them should his client or principal fail to complete. The right of indemnity against the client may be of little value should the client be insolvent. Where margins of profitable trading are small then the sharebroker can easily be severely financially prejudiced should a client fail to meet obligations incurred by the broker on the client's behalf. Where a client dies or becomes incapable of completing, r. 129 comes into effect.

Before the broker can resell or repurchase the client must have either died or become incapable of completion. The first situation creates no problem but in the second situation no test is laid down for guidance as to when a client can be said to be incapable of completing. There must be some concrete evidence that the client will not be able to pay and that mere rumour or suspicion will not be enough to justify a broker closing the account.[28] Similar considerations would seem to be applicable to r. 129 although it is difficult to show this as the collected decisions of the Stock Exchange Association of New Zealand are not reported. The other requirement incorporated in r. 129 is that the broker must make reasonable inquiry that there is no-one legally authorised to complete on the client's behalf. The requirements for this can be ascertained from the tests of common law in the context of a stockbroker's business. It may be considered that r. 129 is too vague and requires too much of the stockbroker, before he resells or repurchases, to be an effective safeguard for him. However, r. 129A can be considered as supplementing r. 129 by providing a more effective procedure which can be invoked without making enquiries and consequent delays. The broker may resell or repurchase as soon as the client *fails* or *refuses* to complete *on demand*. The demand need not be in writing and the resale or repurchase is carried out at the client's *risk* and expense. Therefore an effective safeguard is provided

27. [1973] 2 N.S.W.L.R. 1 (C.A.).
28. Note 23 at p. 237.

for the stockbroker from the insolvency of a client so long as the broker becomes aware of the client's financial difficulties early enough. Should this not be so, it is conceivable that the market may fall and the resale of the shares return very little. Although the risk remains with the client, if he is a man of straw, the right of indemnity will be of little value.

III. NEGLIGENCE

Space does not permit a detailed discussion of the duties in tort of the stockbroker and how the doctrine of negligent misrepresentation affects him.

Briefly it first must be established that there is a special relationship between broker and client before liability can arise. It is submitted that in terms of *MLC* v. *Evatt*[29] brokers are "advisors who carry on the business or profession of giving advice of the kind sought and advice given by them in the course of that business."[30] Second, there is the requirement of reasonable reliance and causation. This must be more difficult to establish where the broker is concerned. The stock market being unpredictable, advice by itself would probably not create the special relationship necessary, especially where it is given gratuitously. But, as advice is considered part of the stockbroker's service, it can be argued that the special relationship exists. Where the broker holds himself out as in possession of exclusive or special knowledge or information, liability is more likely. Although the leading case of *Hedley Byrne* v. *Heller*[31] did not clearly express whether the doctrine of negligent mistatement was based wholly in contract, tort or a fusion of the two, the High Court of Australia in *MLC v. Evatt*[32] considered it to be an action based solely in tort. This affects the usefulness of any disclaimer given by a stockbroker.

The duty of care would appear to be imposed by the law and not created by contractual or unilateral undertakings as can be inferred from *Hedley Byrne* v. *Heller*.[33] Because of this, it can be said that the effect of any disclaimer given by a broker will not be of itself conclusive in refuting liability. It is merely one circumstance in ascertaining whether or not there is in existence at the material time a special relationship as defined by the courts, being a condition precedent to proving liability. A typical disclaimer is that,

> while statements made herein are believed to be accurate, no liability can be accepted for error or omission.

Where a broker, carrying on his profession which includes the giving of advice, automatically disclaims liability from not only that advice which is of minor importance but also that which he

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29. [1971] 1 All E.R. 150.
30. Ibid., 159.
31. [1964] A.C. 465.
32. (1968) 42 A.L.J.R. 316, 320.
33. Note 31.

proffers while holding out some special knowledge or information, it is submitted that the disclaimer may cease to be effective as it conflicts with his holding himself out as an adviser who can be relied on in certain matters. If the practice of issuing disclaimers is general throughout New Zealand, there are strong grounds for arguing that it is ineffective in precluding liability. The person seeking advice has no chance but to go to a person who automatically issues a disclaimer.

IV POSEIDON AND THE RAE REPORT

The boom in the Australian stock market in 1969 resulted in an artificial market with shares being traded at a figure not representative of the value of their company. The Australian Senate Select Committee Report on the Australian securities industry devoted 125 pages to "Insight into the Poseidon Boom".[34] Poseidon rose from a low value, speculative mining company with negligible assets except for various mining options, to a company with high value shares solely on the news that nickel deposits had been found in land over which the company held options. By February 1970 the shares were selling at $280 but thereafter fell sharply in value.

Various irregularities were alleged including a claim that a director of a stockbroking firm and the company geologists misused their positions and bought Poseidon shares for private profit.[35]

These allegations, if true, raise questions as to trading with inside information and breach of fiduciary duties. The Australian Government has announced that in view of the Senate Select Committee's report, it will introduce legislation to set up a National Securities Commission, aimed at the undesirable and fraudulent practices exposed by the committee's report.[36]

The report revealed that unsatisfactory practices including the following were not uncommon in the securities industry in Australia:

1. Sharebrokers acting as directors of companies and using their official and fiduciary position to buy shares in the company for profit.
2. Directors issuing misleading reports to shareholders.
3. Stockbrokers abusing confidential knowledge by excuting large buying orders of other "insiders" through their own stockbroking firm.
4. A corporation dealing in shares of its listed subsidiary in secret transactions with a broker after rigging the market price by false reports and tightening the supply of shares in the market.
5. Brokers knowingly transfering large numbers of shares through their firms in order to maintain a successful trading record of a corporation while the shares remained in the hands of a wholly owned subsidiary.

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34. Evening Post, 24 July, 1974; Australian Financial Review, July 19, 1974.
35. Evening Post, 24 July, 1974.
36. Note 34; per Attorney General, Senator Lionel Murphy.

6. Corporation and brokers alike using large amounts of short-term funds to finance speculative dealings.

7. Employees of brokers not only becoming involved in share trading and speculation but also the employing broker encouraging this by extending credit.

8. Employees engaged in line switching, whereby they could trade on their own account, improperly using clients funds for their own share dealing.

9. Broker-underwriters breaching their fiduciary duties to the extent of initiating excessive boom conditions by questionable practices.

10. Broker-underwriters "shelving' substantial numbers of shares while demand was being stimulated by trading publicity and solicitations. The withheld shares then being sold at a substantial premium.

11. Broker-underwriters financing promoters and directors to large shareholdings.

12. Questionable activities of share-consultants so that share tipping in their newsletters focussed on stocks which the consultant was buying whether personally or through associated companies or under other names.

13. Brokering firms providing the initial capital for the expansion of charting sharetipping and consulting groups involved in speculative trading.

14. The absence in some brokering firms of an adequate system of spot checking that transactions were effected correctly.

15. A lack of consolidated data as to the funding of the brokering firm and the proportion of proprietors' funds together with separate information for firms which dealt on their own account or engaged in underwriting. In the latter situation more funds would be needed to meet the downturns in the market yet the implication of the report would be that these firms are undercapitalised.

16. An overall lack of data of the financial status of firms, especially in view of their reliance on bank overdraft facilities in a tightening market.

From the above shortcomings, and others the report puts forward a case for an Australian National Securities Commission.

Although an organisation as far reaching as a National Securites Commission may prove unnecessary in the smaller, intimate New Zealand market, some form of additional regulation is necessary in the following areas whether through legislation or through the rules of the Stock Exchange Association of New Zealand:

(a) More stringent disclosure procedures for promoters, brokers, underwriters and consultants as to their interests in securities and charges together with the prohibition of certain transactions therein. Separating the functions of underwriters and brokers.

(b) A reporting requirement through a central commission as to events, concerning listed companies. The information being obtained from the companies complying with more stringent disclosure requirements.

(c) A minimum standard of competence and education for brokers and consultants.

(d) Protection of clients' funds with rigorous trust account procedures and minimum capital structure per share volume.

The problem with detailed disclosure requirements is that there may be delays in compliance and it may then be too late to be effective. Nor does the proposal guarantee that the information obtained would be utilised by the investing public; and there are difficulties in enforcing compliance.

These objections could be overcome by placing the burden of surveillance on some "watchdog" regulatory agency along the lines of the United States Securities Exchange Commission. The difficulties of adequate surveillance of the funding and transferral of funds within brokers offices could be handled by instituting stringent audit requirements so that any breach will be disclosed quickly to auditors who report to a commission. Also, the commission could be given authority to issue a stop-order to prevent any dealing in a security once some irregularity is discovered in order to prevent any manipulative trading in a security. Unless there is an extensive stock watch system by an independent commission, the stop order will be useless in preventing abuses as it can only be effective if the commission becomes aware of manipulations at an early stage. The cost of extensive regulatory functions similar to the United States S.E.C. is probably prohibitive in the relation to the limited benefits it would achieve in the New Zealand market.

V. GLOMEX

The case of *Bonds and Securities (Trading) Pty. Limited* v. *Glomex Mines N.L. and Others*[37] provides a good example of some of the unsatisfactory practices in the Australian securities industry.

After dealing with the issues before the Court, Street J. went on expressly to deprecate the disturbing business practices and low standards of commercial morality disclosed in the case. His Honour discussed these practices obiter.

(a) Sharebroker Acting as a Director

The facts revealed that the firm knowingly employed in senior positions two out of four directors of a public listed company: "It is invidious that a broker should thus place himself or allow a senior employee to be thus placed in such a position of conflict."[38] The

37. (1971) N.S.W.L.R. 879.
38. Ibid., 891.

only rules of the Stock Exchange Association of New Zealand which come close to this principle are rr. 42(ii), 44, 140, 140A but none deal specifically with it.

It would seem necessary expressly to prohibit brokers being appointed directors of public listed companies. The potential for conflicting interests is such that it would be detrimental to the standing of the brokering industry if this step is not taken.

The broker's duty is to his client, a member of the investing public, while the director's duty is to his company, a recipient of capital funds from the investing public. Added to this are the personal interests of the broker himself who is in business to make a profit just as are companies and investors.

The concept of an independent agent looking after the interests of the principal is largely eroded if he is an interested director in a listed company.

(b) Stockbroker Underwriting an Issue

The conflict of interests in this situation is that honest and disinterested advice in connection with a flotation underwritten by the stockbroker-advisor would be difficult to obtain, especially in the present case where Pitts was chairman of Directors of the issuing company and underwriting manager of the stockbrokering firm. Notwithstanding the accepted and general practice of stockbrokers to underwrite issues, it would appear an undesirable practice from the point of view of the client should *independent* advice be required. Unless the client goes elsewhere for such advice, the conflict remains. Ideally the two functions should be kept separate and if a broker is to underwrite an issue, he should be prevented from tendering any advice thereon.[39]

(c) Stockbroker Acting as a Sharetrader

His Honour referred to *Hewson* v. *Sydney Stock Exchange Limited*[40] and went on to say,[41]

> Their [stockbrokers] duty is to act for their clients, not to enter the market themselves and trade in competition with them. The *morally* unhealthy practice of sharebrokers being also sharetraders is seen to have been blantantly carried on in the present facts.

Not only do conflict of interest problems arise but also the added likelihood of a firm failing because of its losses on an own account trading.

Although the Securities Industry Act 1970 (N.S.W.) does cover

39. Cf. rr. 44, 140, 137A.
40. (1967) 87 W.N. Pt. 1 (N.S.W.) 442, 425.
41. Ibid., 892.

the disclosure of any interest in securities it is suggested that stricter control by absolute prohibition is preferable. One wonders how consistent is the disclosure of own account trading in Australia after the statement in the Rae Report that separate figures were not available. However, such an attitude would be termed unrealistic by the industry which would consider the concept of a duty to disclose any interest in a particular security before acting for a client on a dealing in that security a more practical control. The obligation to disclose all interests in securities on a register available to the public would hopefully provide sufficient publicity to ensure the broker carries out the duty. This would not be the most effective control but, on a balancing of interests, would be better than no regulation at all.

(d) Stockbroker Acting for Purchaser and Vendor

The learned judge considered that the loss suffered by the plaintiff was due in part to the firm having acted in the dual capacity of broker for both buyer and seller.[42]

Such a proposition is unquestioned in view of the earlier discussion on the marriage of shares.

To prevent any future conflict, an express duty to disclose the duality of roles should be cast upon the broker to enable the client to decide whether or not to proceed.

(e) Trust Account

It was noted by His Honour that the loss might well not have arisen had the rules of the stock exchange governing trust accounts prevented the client's cheque from being paid into the general funds of the broker.[43]

In fact, regulation 3 of the Melbourne Stock Exchange Regulations required every firm to have a trust account with a bank, but as the regulation only obliged the broker not later than the third banking day after receipt of the moneys to pay same into a trust account, the objective of the regulation was defeated.[44]

Although the judge conceded that it was difficult, if not impossible, to frame a trust account procedure to defeat a direct misappropriation of funds by a broker failing to pay in funds or wrongfully withdrawing funds from a trust account, he did consider that a better procedure could be enacted whereby it was not permitted at any stage to mix the funds of a client with those of a broker. This would overcome the problem as occurred in *Glomex* where the client's funds were mixed with those of the broker and subsequently lost because of the broker's

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42. Idem.
43. Ibid., 893.
44. See also s. 523 (ii) N.S.W. Securities Industries Act 1970: Moneys required by this section to be paid into a trust account to be paid within 3 bank trading days after receipt by dealer.

default. He further considered that the argument of difficulty of administration did not amount to a sufficient excuse for failing to adopt a more stringent requirement for trust accounts.

Legislation is needed, obliging the broker to operate a trust account for the benefit of his clients, with the further obligation to place funds immediately into such an account and not through his personal account prior to payment into trust. Adequate provision for the auditing of trust accounts must be made to ensure the legislation is complied with.

Rule 77 of the Association does require members to keep books and records sufficient for an auditor to supply certain information relating to the audit of members' books in order that, when notified by the committee of his exchange under r. 78, the members can supply a certificate of audit. However, the requirement of keeping books does not ensure compliance unless a regular audit is effected. Under r. 78 an audit will be effected only on notification of the committee. This is unsatisfactory; regular audit procedures should be effected. The Rae Report was concerned that much of the Australian broking industry relied on outside credit, in particular bank overdraft finance, to fund its operations. This made the industry particularly vulnerable in times of tightening credit. The requirements for auditing should be as extensive as those provided for solicitors under the Solicitors Audit Regulations 1969. Many of the problems raised in the Rae Report could be solved by sufficient auditing procedures ensuring early disclosure to the appropriate authority of any malpractice or deficiency.

(f) Fidelity Fund

Under the Rules of the Stock Exchange Association of New Zealand a fidelity guarantee fund is established. Any statutory requirement for establishing a fund could closely follow the provision of rr. 144 to 146 of these rules. Specific provision for the establishment of a fund would be desirable as is provided in the Securities Industry Act 1970 (N.S.W.)[45] and the Law Practitioners Act 1955.[46] Whether a theft by a broker of a client's money would be construed by a court as having been "a loss from a sharebroking transaction resulting as a result of a member being unable to meet his financial obligations," is arguable.[47] The obligation of an agent to account to his principal for all moneys entrusted to him would, in the writer's opinion, come within r. 144 and the client would therefore have a good claim. However, to ensure clarity, it is suggested that an extended provision be drafted to cover this possible loss similar to that in the Securities Industry Act 1970 (N.S.W.)[48] and the Law Practitioners Act 1955.[49]

65. Section 46.
46. Sections 78, 79.
47. Rule 144.
48. See s. 58 as to application of fund on defalcation of broker.
49. See s. 89 as application of the fund on the theft by solicitor.

All in all, the fidelity guarantee fund, as set up under the rules is substantially satisfactory in providing for possible defalcation of a member. The main suggestion for changes is to provide a statutory basis for the fund, ensuring that it is kept up to a sufficient level and making specific provision for its application. Notwithstanding this, it would seem obvious that the carrying out of these functions best remains with the executive.

VI. PROGRAMME FOR REFORM

Any regulation of the securities industry involves a concept which is incongruent with the very objective of that industry: that of providing a free market for the easy and efficient acquisition and disposition of securities. Therefore any regulation must be viewed with care to ensure minimum encroachment on this objective.

(a) Licence

It is first necessary to ensure that the licensing requirements of stockbrokers are altered to ensure that a meaningful appraisal of the stature of such broker is made: an inquiry into the character, financial standing and general suitability of an applicant; provision for review of the licence when it is renewed. Updated information for the purposes of review could be supplied with the application for renewal.

(b) Education

Allied to the first proposal is the recommendation that it should not be only the honest applicants who are permitted to act as stockbrokers; competency is also essential. The suggestion that a minimum standard of training is necessary as a prerequisite to holding a licence is but a logical corollary to the industry moving towards and claiming to be a profession. Education could be controlled by either the licensing authority or an institute of brokers especially formed for the purpose.

(c) Discipline

At present the industry is primarily a self-regulated one which does not publish its decisions outside its own members. It is suggested that additional investigatory and disciplinary powers be vested in the commission to complement the present functions of the Association. The reporting of any disciplinary action by the Association to the commission would serve as an effective independent watch over the activities of the industry without unwanted and potentially harmful publicity. The present provisions relating to a disciplinary committee already provide some degree of autonomy; the Stock Exchange Association of New Zealand committee is headed by an experienced barrister who is not a member of the Association.

(d) Interests in Securities

It is advocated that as a minimum requirement any interests in securities held by brokers be recorded by the commission and be made available for inspection by the public.

(e) Insider Trading

It is undesirable for the stockbroker to "wear two hats" and deal in a security of the company of which he is a director or other officer. Any advantage resulting from such practices should be negated and regulation similar to that in the United States of America should be introduced. The whole area of conflict of interests should be reviewed with provision for regulation by the commission in mind.

(f) Stop Order

Although the proposal that the commission have the power to issue a stop-order would necessitate an efficient watchdog system to ensure that sufficient notice is given to the commission to ensure that a stop-order would issue before the damage was done, it is a reform which merits further investigation in the New Zealand context.

Outside regulation of the industry would provide an independent viewpoint which could quite easily work in harmony with the present regulatory functions of the Association. Reference need only be made to the Australian experience with *Glomex* to see that more extensive regulation is desirable. Reliance on the ethical standards of the industry would appear to at present be working against the interests of stockbrokers generally, rather than for them. It is suggested that the emphasis on self-regulation be diminished and weight be given to regulation by the commission.

(g) Trust Account

A final point is that of requiring a trust account procedure which is more effective than that in operation in Australia. Confidence in the industry would be enhanced by this. Added to it should be mandatory audit procedures and perhaps regulation to the extent of minimum capitalisation requirements for stockbroking firms.

VII. CONCLUSION

In conclusion, the writer would stress that overall there is little evidence available to the outsider, to allege that the industry is at present functioning to the detriment of the investor. But examination of overseas experience shows clearly that our present system has the potential for abuse. It may not happen for several years, but when it does, it quite obviously will be too late to safeguard the unwary investor. The question to be asked is whether we wait to take the intelligent and desirable steps to implement those provisions in overseas legislation which are particularly suited to the New Zealand industry. It is the contention of the writer that a consideration be given to our own industry with a view to reform.

P. C. CARRAN.