The Uses and Abuses of Derivatives
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Abstract

The derivatives markets have attracted enormous opprobrium from commentators and the popular press since their rise to prominence in the late 1980’s. Indeed, it is possibly not since the days of Jack the Ripper that activities in the City of London have caused such concern in the tabloids. The question of the best approach to their regulation has remained a common theme ever since. This piece seeks to analyse the manner in which derivatives are created and the people who use them: the uses and abuses of derivatives in short. In particular, it focuses on two issues: first, the failure of internal corporate controls as the main reason for the well-publicised derivatives scandals and, second, the possibility of developing well-understood English law claims to act as a further dimension to the appropriate regulation of derivatives.

Introduction

It is a fact universally acknowledged that derivatives are risky, if not downright dangerous. Their very use is generally seen by market outsiders as an abuse, of good reason and common sense if nothing else. That is really to overlook the real causes of the derivatives-related crises which have hit global financial markets in recent years.

In considering the “Uses and Abuses of Derivatives”, this paper will suggest that the heart of these derivatives risks is the failure of internal controls. As a result, rather than considering the impact of that for regulators simply, this paper will consider the private law implications for derivatives dealers, financial institutions, clients, and shareholders both of clients and of the financial institutions. The starting point is to categorise the two main forms of scandal: first, the rogue trader and, second, the mis-selling cases.

Rogue Trader

For the derivatives markets, the most important recent scandal is probably the Joseph Jett mortgage bonds farrago at Kidder Peabody in the early 1990’s. It is important
precisely because it has nothing to do with derivatives. More to the point it has nothing to do with derivatives but bears all the hallmarks of the derivatives-related scandals. As with Leeson, and other rogue traders at NatWest Capital Markets, Sumitomo, etc., Jett was a single trader who was unchallenged by internal control systems as he fraudulently rolled over loss-making transactions and booked them as profit. This was similar to Leeson’s technique for hiding his losses on SIMEX by booking them as profits.

In short the problem is that internal control systems do not want to challenge profit-making traders and, furthermore, internal controllers do not understand complex products like derivatives and are therefore unable to control their use.

**Mis-selling**

The other form of misuse (to deploy a neutral term between “use” and “abuse”) has been the selling of derivatives products to end-users which are not suitable for their purpose, for the particular end-user, or not suitable simply in the level of risk inherent in them. Litigation has commenced on both sides of the Atlantic against Bankers Trust in a number of mis-selling claims brought by different clients. The various categories of contractual, tortious, equitable and restitutionary liabilities to which Bankers Trust became defendant have been discussed elsewhere. What has been considered less is the availability of private law claims which could be brought either by the shareholders of Bankers Trust against the board of directors for failing to supervise effectively its Treasury department, and by shareholders of Bankers Trust for the loss ensuing to the company as a result of defending claims for mis-selling derivatives to end-users.

**Classifying claims**

In English law there are distinctions to be made between types of claims and remedies which are available in the financial derivatives context for some misfeasance by the seller of a product. Those claims can be analysed as falling into three categories: claims arising out of contract (consent), claims arising out of tort (wrongs), and claims arising on the basis of some unconscionable act by one or other of the parties (unjust enrichment). The tri-partite division between consent, wrongs and unjust enrichment is a modish one, commanding the particular support of restitution lawyers.

The ‘consent’ category deals with issues which have arisen from the contractual or pre-contractual agreement of the parties. Typically such claims will arise out of the law of contract. As considered in the discussion of the confirmation process in

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1 This section is culled largely from an extended discussion of these issues in Hudson, *The Law on Financial Derivatives*, 2nd Edn., (Sweet & Maxwell, 1998).
creating derivatives documentation, there will be a number of situations in which there is an issue as to whether or not the parties have formed any sort of enforceable agreement, whether there is sufficient documentary evidence of such an agreement, or whether the parties have reached agreement on all the terms which were vital to the formation of a viable contract. Claims based on this category would therefore tend to revolve around factual issues as to agreement and remedies based on common law, such as damages for breach of contract, or in equity such as specific performance, injunctions, equitable accounting or compensation.

There is a link with ‘suitability’ as to the appropriateness, enforceability and the availability of claims arising out of the law of contract. For the most part, claims based on consent will tend to settle in the marketplace, unless one of the parties has become insolvent. Where transactions are cash-settled the parties will tend to come to some accommodation as to an amount which would settle their differences. This is particularly the case between financial institutions. Rather than suffer the legal cost of litigation and the reputation cost of unperformed transactions, most market counterparties will tend to opt for settlement. In situations involving non-market users of the products, such as local authorities, the scope for litigation is greater. In particular, market-makers in derivatives products will tend to favour the implementation of their contractually agreed means of termination and settlement, or to rely on market standard procedures (principally because the standard market forms of settlement were agreed between the financial institutions under the ISDA umbrella in any event).

The claims based on ‘wrongs’ will generally revolve around a claim which, in the context of derivatives, is based on the suitability not only of the product sold for the client and for the purpose, but also the suitability of the method by which it was sold and structured. Generally it could be anticipated that a claim in suitability would be brought by a non-financial institution seeking a remedy from a bank which wrongly sold it a particular derivative product. The wrong complained of might fall into one of a number of factual categories:-

(1) that the seller made a misrepresentation or misstatement as to the intrinsic nature and structure of the derivative;
(2) that the seller ought to have given fuller advice as to the effect and risk-profile of the derivative;
(3) that the derivative itself was unsuitable for the purpose for which it was sold and acquired;
(4) that the derivative itself was simply unsuitable for that buyer in all the circumstances; or
(5) that some mistake was made in the course of selling, describing, analysing, pricing, constructing or implementing the derivative which caused the derivative to be unsuitable.

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4 Documentation, Chapter 2.
Evidently a number of well understood claims in the law of tort emerge from this list: misrepresentation, negligent misstatement, negligence, or potentially fraud. Similarly some other claims may emerge on these facts which are not necessarily based on tort: mispredictions, breach of fiduciary duty, or failure to comply with regulatory standards as to client business rules. The issues of mistake, whether mistakes of law or fact, form part of the law of contract or unjust enrichment depending on the circumstance.

The claim in unjust enrichment would be a claim mounted on any one or more of the following factual bases:-

1. to recover specific property lost as a result of the supply of some unsuitable financial derivative product;
2. to acquire specific property in satisfaction of a claim concerning other specific property lost as a result of some supply of an unsuitable financial derivative product;
3. to order payment of money in compensation for some loss suffered as a result of some unsuitable financial derivative product; or
4. to impose financial or fiduciary responsibility on the defendant in respect of some loss suffered as a result of some unsuitable financial derivative product.

There is some potential overlap between the factual basis of some of the claims in wrongs and these claims in unjust enrichment. The basket category ‘unjust enrichment’ itself would appear to classify as exclusively restitutionary those remedies and claims which are properly equitable - particularly in the light of the attitude of the majority of the House of Lords in Westdeutsche Landesbank v. Islington. The claim to recover specific property relies on there being some proprietary right to trace or claim against that property. To a restitution lawyer this claim achieves restitution of that property; to the trusts lawyer it is the assertion of a common law or equitable tracing claim against that property.

The category ‘unjust enrichment’ is therefore intended to cover the broad range of equitable claims and those restitutionary claims which are concerned with the buyer of a derivative seeking to recover property or value from the seller of that derivative.

7 And also the reader’s point of view about the ubiquity of the law of restitution.
8 The term “law of unjust enrichment” is preferred to “law of restitution” in the wake of the House of Lords’ decision in Lipkin Gorman v. Karpnale [1991] 2 AC 548.
Thus, classes 1 and 2 above refer to the recovery of some specific property from the seller, where that seller or some other person has been enriched by the receipt of property from the buyer in connection with the unsuitable provision of that financial derivative. Classes 3 and 4 refer to some unconscionable act on the part of the seller or some other person which results in an award of monetary compensation or the imposition of financial obligations based on constructive trusteeship.

In attempting to reach a catch-all standard for claims in this area, a test of “Suitability”, it is submitted, would be the most apposite. “Suitability” is described by some of the commentators as an ‘emerging standard’\(^\text{12}\) derived from US financial regulation and as emerging from UK regulation.\(^\text{13}\) In the Conduct of Investment Business rules there is specific mention of suitability. The SIB’s conduct of business rules\(^\text{14}\) deal with derivative transactions under which private customers have a contingent liability to make payments at some time in the future, there is a requirement that a two-way customer agreement is put in place. The policy aim of the regulatory principles is to protect customer rights by ensuring the suitability of seller’s product recommendations and discretionary transactions. The regulation of such agreements requires that there is no restriction on the part of the advisor to restrict its liability in respect of its obligations to advise without negligence and with due skill, care and diligence. With reference to complex financial products, which may involve derivatives, the advisor is required to ensure that the investment is suitable for that particular customer.

Suitability as considered in the context of this section is in the form of the collective term for a group of common law, statutory and equitable claims to do with the liability of the derivatives dealer. There has been some debate as to the need for a concept of suitability within the English common law to protect unsophisticated users of financial derivatives from the dangers inherent in the products and also to protect them from the attentions of experienced sellers.\(^\text{15}\) Much of the argument circulates around the issues which typically arise in the debate as to the need to regulate financial derivatives because they are risk-laden time-bombs in the hands of the unwary. The principle argument for the development of a distinct category of liability on grounds of suitability is that derivatives constitute a new risk which is deserving of a specific, tailor-made remedy. The counter-argument is that there is a sufficiency of common law and equity able to deal with these claims.\(^\text{16}\) This argument is capable, at its edges, of running into the anti-regulation argument that existing regulatory safeguards ought to be sufficient to protect the unwise or unwary on entering into derivatives agreements.\(^\text{17}\)

The other sense in which the term “suitability” is frequently used in the financial services context is in the regulatory field. As a point of re-emphasis, the point of view of this section is that English law does have enough common law and equitable forms

\(^{13}\) See Blair, *Financial Services: The New Core Rules* (Blackstone, 1991), 94.
\(^{14}\) SIB Rules, Ch. III, Pt. 2.
\(^{16}\) See especially Greene, *op cit.*
\(^{17}\)
of action to cater for the needs of the inexperienced buyer - but that the term “suitability” is a useful collective term for their application and motivation in this context.

**Derivatives dealer liability under English law**

In the context of derivatives there has been one reported decision which has considered the specific liability of the sellers of financial derivatives in the decision of Mance J. in the case of *Dharmala*. This case summarises precisely the issues which are specific to the selling of financial derivatives in general and interest rate swaps in particular.

There are indications in the judgement that the relationship between the parties is of a particular nature that it needs to be considered on its own facts. By extension then, the circumstances of all sellers and buyers of financial derivatives need to be considered on their own facts. In particular Mance J. held that not all statements made by BT are necessarily to be considered representations if DSS is to be expected to exercise its own skill and judgement as to that statement. To this extent the Bank of England’s London Code is cited with approval in its approach to each individual client and an evaluation of that client’s level of knowledge and expertise in the requisite field.

In relation to one of the two swap transactions at issue, Mance J. was more critical of BT because the seller’s marketing material tended to emphasise the likelihood of gain rather than the risks of the loss, and further that that material might have given a misleading impression of the effect of the product. Mance J. found expressly that such a transaction would have founded liability for the tort of misrepresentation in respect of an inexperienced counterparty. On the facts, however, DSS appeared to be suitably experienced and diligent to form its own, independent assessment of the effect and risk of the swaps proposed by BT. Mance J. thus emphasises the relativity involved in assessing potential liability in this context. A counterparty which was demonstrably incapable of ascertaining the risks involved, or a counterparty which had not been as pro-active as DSS in pursuing these particular structures and relying more on the seller, would appear to have good grounds for a claim based on misrepresentation.

As to the general claim based on “breach of duty”, Mance J. found that many of DSS’s requirements for the swaps had not been communicated fully to BT to the extent that the were alleged by DSS to have existed in any event. Further, economists’ predictions of the future movement of the US economy which had been supplied by BT were reasonably made and based on detailed research. As such, it was held, BT ought to have no liability based on the outcome of those economic predictions which had not, in themselves, caused DSS to enter into the transactions.

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18 This section is culled largely from an extended discussion of these issues in Hudson, *The Law on Financial Derivatives*, 2nd Edn., (Sweet & Maxwell, 1998).
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Importantly, in general terms, there was no duty on BT to act as general advisor to DSS. Furthermore, Mance J. was explicit in his finding that the courts should not assume such duties in all cases. A duty of care, under any of the heads sought be DSS, should be inferred only where it was justified on the particular facts. DSS were experienced in financial matters and as such should be expected to understand the partially speculative nature of the transactions. On these facts, it was held, there was no reason for BT to be saddled with a responsibility to advise DSS generally in the manner suggested by DSS’s counter-claim.

Contrary to the risks associated with mis-selling derivatives, there are the personal risks taken by the officers of the buyer in entering into these products. In one decided US case, directors have been held liable by shareholders for failing to protect the company against market movements by means of hedging derivatives. Additionally, those directors also run the risk of litigation where their use of derivatives causes loss to the company.

*Dealers' representations*

In the context of a financial derivative product, it is the uncertainty of future market movement that forms the rationale for the entire transaction. That is so whether the transaction is constructed around speculative gain or prudent risk management. There are two potential categories of issue: resultant loss caused by unanticipated movements in market rates ('failure of model') and loss caused by a reckless level of risk being taken by the buyer on the advice of the seller ('suitability failure'). In the context of “failure of model’” the allocation of risks lies with the advisor in seeking to match market volatility with the forecasts and assessments set out in the pricing model. Failure to anticipate all of the resultant movements may, of course, stem straightforwardly from negligence and thereby be actionable in tort. The issue would arise as to the foreseeability of the loss actually suffered. Alternatively, the buyer could seek restitution on the basis of a failure of basis: that is, the movement of the appropriate markets in a way and to an extent which the parties had not expected. In reference to options on equity markets, for example, it would be advantageous to the commercial parties to specify a maximum volatility which they anticipate in the market, such that excess volatility (outside their expectations or common intentions) would be discounted. It is submitted that volatility outwith those boundaries would give rise to a claim founded on failure of basis.

The claim based on “suitability failure” would arise where the risk which the buyer sought to manage was not met by the risk inherent in the product bought. For example, the use of an interest rate swap which did not pay an interest rate to the

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24 This section is culled largely from an extended discussion of these issues in Hudson, *The Law on Financial Derivatives*, 2nd Edn., (Sweet & Maxwell, 1998).
25 At this level there is a potential claim, as considered above with reference to reckless risk-taking.
buyer equivalent to the size of risk inherent in its existing debt portfolio (a rate equal to \( x \)), but rather one which contained an element of speculation (thus specifying a rate equal to \( x + y \)). The element that equalled \( y \) would be unnecessary for the purposes of debt management. The factor to be proved by the buyer claiming suitability failure would be that the element \( y \) constituted an unsuitable addition of risk which went beyond the basis upon which the transaction was created. It may be that the element \( y \) arises from market disruption which the parties had not foreseen but which was not covered by the contract. Alternatively, \( y \) might be an element which was knowingly added to the transaction but which constituted an unacceptable increase in the risk incumbent on the buyer.\(^\text{26}\) 

**Shareholder remedies**

The future of private law in relation to the use and abuse of derivatives will depend upon the ability of shareholders to control the use of derivatives by banks or their clients, the obligations of the fiduciary to control the use of derivatives and the concomitant obligations of any fiduciary to provide information as to the use of derivatives.

**Fiduciary duty to control**

It appears that there are two contexts in which this form of liability might be important. The first is where a seller is advising an institution as to its derivatives investment strategy in circumstances where it occupies a fiduciary relationship in respect of its client. As with the facts of the leading cases, often the use of information acquired from the fiduciary relationship to make profit is itself grounds for liability. The second situation is where a market-making seller provides a structure to its client in relation to which it makes a profit for itself. There is straightforwardly a conflict between the fiduciary obligations of protecting the beneficiary and the need to make profit.

The further issue is the nature of the remedy against the fiduciary.\(^\text{27}\) If the fiduciary had used trust property to generate a profit, then that profit would be said to derive from that property. Therefore, it would appear that in relation to the rule against profit-making by fiduciaries, the profit ought to be held on proprietary constructive trust for the trust by the fiduciary.\(^\text{28}\) In *Boardman v. Phipps*, Lord Cohen held that the fiduciary should be ‘accountable to the respondent for his share of the net profits

\(^{26}\) It was this latter, factual category which founded Proctor and Gamble’s claim against Bankers Trust in relation to a claim for a loss of approximately US$160m caused by the selling of ‘high octane swaps’ for the corporate party’s debt management which had an in-built exposure to speculative movements in the underlying markets. The corporate party brought the action on the basis of the bank’s allegedly negligent advice in selling the product without recognising its unsuitability both for the purpose and the particular buyer.

\(^{27}\) For a fuller discussion of this issue see Hudson, *Principles of Equity and the Law of Trusts* (Cavendish, 1999).

\(^{28}\) In *The Law on Restitution*, Burrows argues that in the context of unjust enrichment, this award is restitutionary, although this form of constructive trust is more usually proprietary.
which they derived from the transaction’: it is not clear whether that accounting is on a proprietary or a personal basis. The reference to ‘net profits’ presumably refers to profits made after deducting the expense of making them. However, Lords Hodson and Guest affirmatively hold that the confidential information obtained by Boardman was the property of the Phipps trust. Therefore, the profits generated by the fiduciary ought properly to be considered to have been in equity the property of the Phipps trust throughout.

The other possible approaches would be simply to make good the amount lost to the trust in money terms. This does not amount to a proprietary remedy necessarily. In *Target Holdings v. Redfern*, Lord Browne-Wilkinson identified three possible remedies in connection with a breach of trust. The first was compensation, the second was the reinstatement of the trust fund, a proprietary remedy, the third was a payment of money to the trust equal to the value of the amount lost by the trust fund. This final approach is reminiscent of a remedy for unjust enrichment being equal to the value subtracted from the trust fund by the enrichment of the fiduciary.

The amount of interest to be paid by the constructive trustee will differ according to the trustee’s honesty. As a result of the decision in *Westdeutsche Landesbank v. Islington L.B.C.*, where the trustee knew of the unconscionability of his actions, he will hold any trust property on trust from the time when he first has that knowledge. Such a proprietary right under constructive trust principles will then give the trust a right to receive compound, rather than merely simple, interest. Where the constructive trustee had no such knowledge, no proprietary claim arises and only simple interest will be payable.

**Fiduciary duty to provide information**

Information is the key to control of the use and abuse of derivatives. As considered above, all derivatives debacles have been caused by fraudulent, rogue trades or a straightforward lack of expertise and information in the derivatives field. In relation to boards of directors or agents, the question arises as to the obligation to inform their members as to derivatives policies. The shareholders of end-users of derivatives require information as to the treasury department’s policies in relation to speculation and risk management. The shareholders of financial institutions similarly need to be informed as to the compliance procedures of the bank and the suitability of transactions with end-users.

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29 The nature of the remedy in *Boardman* is however somewhat problematic (see ‘Underhill & Hayton Law Relating to Trusts and Trustees’ (15th edn.), Hayton (Butterworths, 1995), 356 discussing particularly *Regal v. Gulliver* [1942] 1 All ER 378, [1967] 2 AC 134n). Therefore, it is not impossible for personal rights to be translated into proprietary rights on the happening of a suitable event. The distinction between *Reid* and *Westdeutsche* would be said to be, on Lord Browne-Wilkinson’s terms, the knowledge Reid had that his receipt of the payments was a breach of the trust held in him by his employers.


Dealer’s unconscionable profit

Where a dealer makes a profit from an unsuitable product that would appear to be an unjust enrichment remediable by a restitutionary remedy. In the wake of the decision in Westdeutsche Landesbank v. Islington L.B.C.\(^\text{32}\) where one party receives the property of another with knowledge of some factor in that transaction affecting its conscience, then the property so received is to be held on constructive trust by the recipient. By extension, where that property is received but then passed on by the recipient, it will attract personal liability to account to the payer under the doctrine of knowing receipt;\(^\text{33}\) or, if there is no receipt of the property but simply some action as an intermediary in setting up the transaction, the intermediary will face personal liability to account as a dishonest assistant where the transaction takes some reckless risk as to suitability of the product for the context.\(^\text{34}\)

As considered with reference to the Dharmala case above,\(^\text{35}\) the issue of undue influence may also turn on the relationship between the buyer and the seller. In circumstances where the buyer would typically rely on the seller for advice without recourse to any other expert, perhaps as its house bank which provided all its finance requirements, and where the client has no particular financial expertise of its own, the seller must be particularly careful in marketing complex products. In Dharmala itself, DSS argued that BT owed it a duty to suggest more straightforward products which would have achieved its objectives. Mance J. found that DSS had been involved in and eager for the particular product created. However, where a more risky and complex product is foisted on the buyer by the seller, in circumstances where vanilla, less risky products would have achieved the same goals, it is suggested that the seller is at risk of a claim for undue influence brought by the buyer.

A claim for undue influence, if successful, permits the victim to set aside the transaction which has been created as a result of that undue influence.\(^\text{36}\) This action is categorised as a form of “constructive fraud”.\(^\text{37}\) The victim will be able to set aside a transaction on the basis that there has been some form of undue influence but not as a means of protecting itself from the result of its own folly or failure to act.\(^\text{38}\) Furthermore, the victim will not be able to establish undue influence simply because there is inequality of bargaining power between transacting parties; rather, the buyer must show some undue influence over and above that.\(^\text{39}\)

The issue is this: if equity will respond to a fiduciary who takes unacceptable levels of risk with the trust fund, what is it that will lead to a person being made a fiduciary? IN a fiduciary relationship\(^\text{40}\) although, it is suggested, there are circumstances in which

\(^{36}\) See Snell’s Equity, 29th edn. (Sweet & Maxwell, 1990), 550.
\(^{38}\) National Westminster Bank v. Morgan [1985] AC 686; although it is perhaps unclear how this doctrine is to be applied in the wake of O’Brien.
the advising seller so inter-meddles with the affairs and risk management objectives of
the buyer that the seller must come to occupy a fiduciary relationship in respect of its
counterparty and client.\footnote{Lloyds Bank v. Bundy [1975] QB 326, a decision which concerned advice given by a bank to an old
[1985] AC 686.}

The role of the equitable doctrines of undue influence, constructive trusts to give
effect to the settlor’s intentions and of common intention constructive trusts, were not
issues raised by Lord Browne-Wilkinson in \emph{Islington}. In \emph{Barclays Bank v. O’Brien}\footnote{[1996] AC 669.}
the House of Lords established the need to take independent advice. The issue arises
then: what advice will dispel the undue influence? Further to \emph{Credit Lyonnais v. Burch},\footnote{[1997] 1 AC 180; CIBC
Halifax Mortgage Services Ltd. v. Stepsky [1996] Ch. 1; [1995] 4 All ER 656; Banco Exterior Internacional SA v. Thomas
it is not clear whether there is the possibility of undue influence in OTC
derivatives market or whether these multinational organisations are simply arm’s
length parties. The decision in \emph{O’Brien}\footnote{[1994] 1994\ 1 AC 180, [1993] 3 WLR 786.} as to the application of the principle of
undue influence in the provision of guarantees in respect of domestic mortgages,
could be extended to cases of commercial guarantees or collateral agreements which
are obtained in respect of derivatives transactions. It is possible to argue that
\emph{O’Brien}\footnote{[1994] 1994\ 1 AC 180, [1993] 3 WLR 786.} is a decision which is also about risk allocation. In compiling a test for
equity in commercial situations, a test of ‘commercially acceptable conduct’ may be
better than ‘unconscionable conduct’. As with \emph{Tan},\footnote{Royal Brunei Airlines v. Tan [1995] 2 AC 378, [1995] 3 WLR 64.}
there would be an establishment of an objective standard of probity.

\textit{Tortious liability: fraud and negligence}

Further to what has been said above in relation to unconscionable profits from
unsuitable derivatives transactions, the more straightforward common law claims will
revolve around dealer fraud or negligence. The fraud-based claims would involve
matters of fact, deduced usually from tapes of conversations between the parties,
which are not susceptible to much legal analysis. The issue of one more of regulatory
control in relation to the activities of traders or in the hands of shareholders seeking to
control the affairs of the company as to the observance of conduct of business
requirements.

A further issue then arises in relation to bribes and unlawful acts, which takes a much
tougher and clearer line on the appropriate remedy. Where a person committing an
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of such an act, the fiduciary is required to hold any property comprising the bribe on
proprietary constructive trust for the beneficiaries of the fiduciary duty. That proprietary constructive trust requires that any profits made are similarly to be held on constructive trust. Similarly, any losses made as a result of investing the bribe will be required to be made good by the constructive trustee.\footnote{See also \textit{Reading v. A-G} [1951] A.C. 507.}

The core rule was set out by the Privy Council in \textit{A-G Hong Kong v. Reid}.\footnote{[1994] 1 AC 324; [1994] 1 All E.R. 1} The former Attorney-General for Hong Kong had accepted bribes in relation to the prosecution of individuals within his jurisdiction. The bribes which he had received had been profitably invested. Lord Templeman held that a proprietary constructive trust is imposed as soon as the bribe is received on the recipient of the bribe. This means that the employer is entitled to any profit generated by the cash bribe received from the moment of its receipt. Similarly, Lord Templeman held that the constructive trustee is liable to the beneficiary for any decrease in value in the bribe and also for any increase in value in the bribe.

Negligence is a slightly more difficult concept in this context. The ways in which sellers and buyers can be negligent in relation to derivatives products are numerous. For the seller the fundamental issue would be making an error in the creation of the product by means of mis-pricing, or mis-documenting the transaction. This problem could be dealt with most straightforwardly by means of an action in relation to mistake or for rectification of the contract. The more difficult forms of negligence would relate to a mis-allocation of the type of product to the commercial circumstances of the buyer. This might arise from a negligent appraisal of the risks involved in the product, or a negligent mis-understanding of regulatory, legal or capacity risk. The common thread, again it is contended, is the unsuitability of the product for the circumstances.

From the perspective of the negligence of the buyer’s agents (in particular its finance director, treasury area, professional advisers, and board of directors) the categories of negligence are similar to those for the seller. The action brought on behalf of the buyer’s shareholders (subject to what is said above about the availability of an action for negligence) would be in pursuance of negligent mistakes or mis-appraisals of the nature of the obligations acquired. For the buyer the mis-appraisal would be orientated around either the acquisition of an obligation which becomes unacceptably large or around the failure to hedge adequately a commercial risk.

\textit{Too little knowledge is the dangerous thing}

In the information age, it is ironic that the most hi-tech industry in the global trading village is generated scandal, deceit and loss by means of a lack of communicated information. Derivatives-related scandals at institutions like Barings and Kidder Peabody have arisen due to a lack of information being supplied to senior management, and inertia among senior management to seek more information from traders who were turning in extraordinarily large profits in unlikely markets. The mis-selling of derivatives to end-users arose out of a lack of suitable information being
supplied to the end-user as to the nature and risks of the product. The second context of information shortcomings about derivatives arises in relation to the information that is available to shareholders about the derivatives strategies used and also about the basis on which that business is conducted.

Derivatives are not necessarily dangerous. It is a lack of information and a lack of knowledge that are the dangerous things. Regulation of derivatives needs to be orientated around the user of the product and also around the assets which that end-user ought to be able to put at risk in entering into those products. Private law remedies ought to reflect the need for informed shareholders and informed management to control the use, and concomitant abuse, of products by their organisations. The litmus test, it is suggested, ought to be a measurement of the suitability of the product for the context in which it is to be used. In relation to claims based on consent, wrongs or unjust enrichment, that is the most consistent benchmark for the availability of a remedy.

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