Financial Law Panel

Fund Management and Market Transactions

A Practice Recommendation

September 1995

Financial Law Panel Limited
125 Wood Street
London EC2V 7AQ

Tel: 0171 606 2566
Fax: 0171 606 0040

The function of the Financial Law Panel is to identify areas of uncertainty in the law affecting financial markets, and to seek to remove them or limit their scope. This practice recommendation has been prepared to assist in this process. Its contents cannot be taken as legal advice in relation to a particular transaction or situation. It does not obviate the need to take legal advice, if appropriate.

CHAPTER 1
THE PROJECT AND ITS BACKGROUND

When the Financial Law Panel was established, several subscribers alerted us to legal uncertainties that arise when companies in the fund management industry enter into wholesale financial market transactions. Those problems have been scrutinised by working groups at the Financial Law Panel for the last two years and the results of their efforts are contained in the subsequent chapters in this paper.

The fund management industry in the UK, concentrated in London and Edinburgh, has grown in recent years to become one of the most important constituents of the financial markets. Fund management companies are responsible for a major part of the turnover of the market not only in equities and fixed-interest stocks, but also in government securities and increasingly in derivatives. London is now the world's principal centre for the management of international funds[1].

Fund managers are not an homogeneous group. A manager may be the London branch of an overseas private bank which manages the assets of rich individuals; it may be a member of a financial services group which handles the investment of the funds attributable to unit trusts and other financial products of the group; or it could be a subsidiary of a major insurance company which manages the investments attributable to various groups of policy holders and which also offers its expertise to pension funds and others outside its group. Perhaps best known are the large independent fund managers who act on behalf of hundreds of clients drawn from widely differing categories.

Whatever their differences in size or commercial objectives, fund managers have one important legal characteristic in common: in their market activities they will usually act as agent for one

---

1 ie funds (other than bank deposits) managed outside the country where the owners are resident.

or more of their clients. Their function is to provide expertise in return for a fee; they are not paid to take credit or transaction risk and will not therefore (save in exceptional circumstances) take positions as principal in transactions concluded for their clients. The English law of agency can be complex and difficult. Although in practice the operations of fund managers in the UK markets have not produced serious problems, the potential difficulties of uncertainty cannot be ignored.

Before describing how our project has developed, it is important to say that we have confined ourselves to questions of legal difficulty. There are in the market several areas where standard practice has yet to emerge. There is, for example, no settled view on the form of warranty which a fund manager should give as to its clients' powers. It is not the Panel's function to moderate between market sectors on commercial matters, nor to make recommendations as to how business risks should be allocated. The Panel's concern is to point out those places where legal risks might be lurking and to suggest ways of clarifying the position, when the parties have decided how to deal with the question commercially.

One of the topics frequently referred to is the question of disclosure of the identity of the clients of fund managers. Internationally, the control of money laundering and the need for transparency in complex financial dealings are reducing the number of situations where it is acceptable for institutions to deal in markets without identifying the underlying principal in the trade. There remain, however, many situations where the practice of managers dealing for unidentified clients is accepted and sometimes unavoidable. There are a significant number of transactions carried out where the market counterparty[1] is not aware of the identity of the fund manager's underlying client.

The conclusions drawn from the projects dealt with by our fund management working group tend to suggest that non-disclosure of the identity of the client does not of itself give rise to problems of legal uncertainty or, to the extent that it does, they can be satisfactorily addressed

---

1 Throughout this paper we have referred to the fund manager's counterparty as a "counterparty" or "market counterparty"; to the fund manager as such; and to the fund manager's client as "client" or, when considering the situation against the background of the law of agency, "principal".

by the recommendations and clauses set out in the rest of this paper. In a transaction where the counterparty does not know for which client the fund manager is acting there will, of course, be other kinds of risks that may need to be addressed. However, non-disclosure - although certainly important - is not central to the question of legal uncertainty. The moderation of commercial risks, as we have said, is a matter for others.

In order to clarify the legal issues the secretariat of the Financial Law Panel prepared a private paper[1] which analysed a number of the legal uncertainties and the underlying legal principles. After a period of consultation with market participants it was clear that four specific areas of legal uncertainty were of particular relevance, and each was considered separately. Each of those four areas is dealt with in the subsequent chapters of this paper and is briefly described below.

Documentation

Compared to some other areas of the wholesale financial markets, the practices in the fund management industry adopted for documenting the relationship between fund managers and those with whom they transact are not settled.

Agency

We consider the problems that arise where the agency status of the fund manager is not recognised in the legal documentation governing the relationship of the parties and in particular the consequences that arise from that agency status in relation to the law of netting and set-off.

---

1 *Legal Uncertainties in Fund Management* (December 1993).

Legal Capacity

We consider the choices available for addressing the legal capacity of the fund manager's underlying client(s).

Unallocated Trades

We set out a recommended clause which will deal with the situation that arises where fund managers deal with counterparties before they have allocated the deal amongst their various clients.

CHAPTER 2
THE FORM OF DOCUMENTATION

As markets develop and types of financial activity form consistent patterns, the documentation which is used grows towards a standard approach, both in its form and its content. The recent trend has been towards the adoption of industry standard documentation settled by trade associations or more informal groups and thereafter adopted generally. More traditionally participants in markets have developed their own documentation. In due course, the documents used by significant market participants become very similar.

In complex financial markets the standardisation of documents, whether it arises by usage or by the adoption of terms drafted for the purpose, is to be welcomed. It is clear that it would be in the interests of all concerned if there were a settled form of legal documentation covering the framework of the relationship between fund managers and their market counterparties.

Unfortunately, the fund management industry has developed too quickly for the process of standardisation to occur naturally, and trade bodies have not so far produced a standard form of agreement for use between fund managers and their market counterparties. This state of affairs is unsatisfactory in three respects:

(i) Banks and securities houses which have their own standard forms of agreement for customers usually draft their documentation on the basis that the customer is acting as principal. When such a document is adopted by the parties, the fact that the contract ignores the agency status of the fund manager and the consequences that flow from it can cause dangerous uncertainties. Sometimes the position is confused by attempts on the part of the fund manager to clarify the position by accepting the document, but adding a gloss which imports the existence of the agency capacity into a document drafted to cover a different relationship.

(ii) Both the fund managers and their counterparties are powerful commercial organisations, which are not willing to be pressurised into accepting contractual terms which they feel are contrary to their interests. This can result in time-consuming arguments about comparatively unimportant terms. At worst, the legal departments of the parties may still be conducting contract negotiations months after a trading relationship has been established.

(iii) The lack of a common standard in the industry means that there is insufficient focus on the core issues which we believe must be addressed by documentation and which are identified in chapter 1 above. Even when the parties put in place a contract governing their relationship, it often deals inadequately with the central matters.

Regulatory Requirements

The great majority of fund managers will be members of, and have their business activities regulated by, Investment Management Regulatory Organisation Limited ("IMRO"). It is possible for managers who conduct fund management activities within a wider corporate activity sometimes to have as their regulator The Securities and Futures Authority Limited ("SFA"). This is, however, unusual.

The market counterparties will either be members of SFA in respect of the business concerned, or will be exempt from the relevant requirements of the **Financial Services Act 1986** under the terms of **Section 43** of that Act. In the latter case the counterparty will have undertaken to observe the terms of the London Code of Conduct, settled by the Bank of England, which governs conduct in the wholesale financial markets (the "London Code").

These three regimes stipulate a minimum level of documentation required between fund managers and their market counterparties, as follows:

(i) **SFA**

For the purposes of SFA rules, fund managers may be classified as *market counterparties*[1] in some circumstances, but would fall to be treated as *ordinary business investors* in others. In practice, most fund managers will be treated as *ordinary business investors* for most purposes.

There are, of course, detailed provisions requiring an SFA member to send to its customers *risk warnings*, *contract notes* and *confirmations*, and setting out in detail the required contents of those documents. Except in the most unusual case, however, the rules will not require that there is between the SFA member and its fund manager customer a *two-way customer agreement* (ie a written agreement which the fund manager has accepted in writing).

However, there are some matters which will usually be dealt with by a written agreement. Under rule 5-6, unless there is an agreement in writing to the contrary, clients of the fund manager who are identified to the SFA member become *indirect* customers of the SFA member. Neither the fund manager nor its counterparty will usually wish this relationship to arise and accordingly the parties will almost certainly exclude the operation of this rule by agreement.

In addition, a written agreement will be required if the fund manager agrees that money held for it by the SFA member should not be treated as *client money*[2]. In practice, many fund managers find this unacceptable and indeed require written confirmation that the client money rules will apply.

---

1 Italics are used in this chapter to indicate a term which is defined in SFA or IMRO rules.

2 The Financial Services (Client Money) Regulations 1991, paragraph 2.02.5.a.

(ii) **IMRO**

In relation to a fund manager which is a member of IMRO, the counterparty will be a *market counterparty*. There is accordingly no specific requirement for a customer agreement.

(iii) **London Code**

The London Code sets out the general standards and controls which the Bank of England, as regulator of the wholesale money markets, requires to be adopted by market participants in the areas covered by the London Code. Although strictly these areas cover a range of treasury products narrower than that traded between fund managers and counterparties, some of their transactions will fall within the ambit of the London Code.

The London Code deals in some detail with the documentation of individual transactions. For example it states categorically that,

> "Where sale and repurchase (or stock borrowing and lending) transactions are entered into, proper documentation and prior agreement of key terms and conditions are essential."[1]

In addition, it addresses the use of master agreements and contracts setting out standard terms and conditions. In relation to the preparation of such documents paragraph 107 says,

> "It is in the interest of all principals to make every effort to progress the finalisation of documentation as quickly as possible. In some markets, such as repo, or in other circumstances such as [new counterparties or deals at non-current rates], documentation should be in place before any deals are undertaken. More generally, however, the Bank believes the aim should be for documentation to be in place within three months of the first deal being struck.

---

1 July 1995 edition, paragraph 110.

> Failure to agree documentation within this timescale should cause management to review the additional risks that this might imply for any future deals with the counterparty concerned. Factors which may influence managements' views include whether they can take comfort on their legal position from the mutual confirmation of terms with a particular counterparty; or where the delay is in putting in place multiple master agreements for products that are, in the interim, subject to previously agreed documentation."

In summary, therefore, the position is that the rules made under the **Financial Services Act 1986** do not specifically require the existence of a master agreement governing the general relationship between a fund manager and its market counterparties. However, written agreement is in practice necessary to deal with specific issues. The London Code endorses the view that master agreements are desirable and that specific agreements are essential for certain specialised activities.

The Panel's view

There is clearly an acceptance by financial markets, witnessed by the terms of the London Code, that master agreements (used below to mean agreements setting out the main terms which are to govern dealings between two market participants) are desirable. In relation to specialised kinds of activity, a separate master agreement specific to that activity and adapted to meet the requirements of the parties is widely considered necessary.

The Panel believes that the factors which lead to this view apply to the relationship between fund managers and market counterparties even more strongly than they apply to the rest of the wholesale markets. There is a particular need for clear documentation of the terms of dealing in this area because:

(i) there are specific and difficult legal issues which affect the relationship and which must be addressed unambiguously in the interests of all parties. These issues are discussed in subsequent chapters of this paper;

(ii) the underlying investors of the clients of fund managers are often individuals who are, for example, beneficiaries of pension schemes or investors in collective investment schemes. These individuals are not personally concerned in the markets' arrangements. It is right, however, that the market participants should take all steps reasonably open to them to eliminate uncertainties in the contractual arrangements which might ultimately operate to the detriment of the underlying investors.

The Panel believes that the parties should agree properly drafted documentation dealing with the main terms of the relationship between fund managers and their market counterparties. Such documentation should be finalised and executed as soon as possible after a trading relationship has been established. The London Code states that a period of three months should be the aim for arrangements to be made for the purpose of the wholesale markets generally. The Panel's view is that this should be regarded as a maximum for the fund management sector and that it should often be possible to finalise documentation more quickly.

If the recommended procedures are to be put in place without delay when a trading relationship develops, it is essential that the terms of any master agreement should be reasonable and should be limited to those which are important. Unnecessary delay in negotiating terms which are unacceptable to one party, or deal with matters of little practical significance, should be avoided.

Given time, the dealings between market participants would no doubt result in the evolution of a number of agreements with very similar content and wording. Because of the significance of the fund management industry, however, we think that it is undesirable simply to allow a market standard to evolve. We recommend that market participants, perhaps through their trade associations, should agree an appropriate form of master agreement. That standard form should:

(i) deal with the specific issues discussed in chapters 3, 4 and 5 of this paper;

(ii) accommodate the possibility that the parties may well execute other forms of standard agreement to deal with particular products or activities; and

(iii) otherwise limit its ambit to those areas agreed as practically important.

The settling of standard documentation is never as easy in practice as it sounds in theory. However, given the success which has been achieved in this area in recent years by the trade and professional associations of the financial markets, the Panel is confident that this task can be completed quickly and successfully.

CHAPTER 3
AGENCY

The technical problems which might arise from contracts between fund managers and their market counterparties can almost all be traced to the fact that a fund manager is an agent who contracts on behalf of one or more of its clients. The client is bound by the contract made on its behalf, but may be unaware even that it has become a party, at least in those cases where the fund manager has discretionary power. The introduction of a third party into the contractual structure inevitably complicates the legal picture and these complexities are often increased in practice beyond those which are unavoidable, because of the way in which fund management business is operated. For example, the fund manager may decline to disclose the identity (or even the existence) of its client. It may contract sometimes on behalf of clients and sometimes on its own account. Occasionally the counterparty may itself be acting as an agent (for example in a stock lending transaction).

Other chapters of this paper deal with problems which have been recognised for some time within the industry. In addition, there is a consequence of the agency relationship which has assumed great importance recently, as fund managers have become responsible for a significant part of the activity in the wholesale markets. In wholesale markets participants often trade either as agent for clients or as principal to meet the requirements of their clients. The volume of transactions between them is very large and much greater than is necessary to cover their proprietary positions. The exposures are so high that the credit risks are tolerable only if the liabilities between market participants can be assessed on a net basis. The topic has been the subject of two Guidance Notices from the Panel.[1]

---

1 *Guidance notice: Netting of Counterparty Exposure* (November 1993) and *Netting of Counterparty Exposure: Foreign Exchange Transactions* (September 1994), issued in conjunction with the Banking Law Sub-Committee of the City of London Law Society.

The legal position is clear where the two parties concerned in the netting arrangements are both acting as principal. Where one or both are agents, however, the picture changes. The permutations of facts become very complex and careful analysis is needed to establish the legal rights and obligations of the parties. Often now market participants need to be sure of their ability to net their obligations to and from their counterparties because their requirements for capital are fixed by reference to their potential exposures. In order for them to form a clear view of their real liabilities the legal relationships with their counterparties must be clear and properly documented.

In particular, banks which are subject to Bank of England supervision will only be permitted to view the exposure to an individual counterparty on a net basis for capital adequacy purposes if there is in place an effective agreement permitting the netting of debts between the two. The counterparty of the bank is the principal in respect of the transactions concerned (ie the fund manager's client). It is therefore necessary for the bank to have an agreement, which includes the relevant netting provisions, with each client of the fund manager against whom it might wish to net. That agreement itself may be made by the fund manager on behalf of each of its clients.

Market Documentation

Until recently the standard form agreements used in the wholesale financial markets tended to ignore the problems which arise from the fund managers' agency status. They either assumed or stated that both parties were, or were to be taken to be, acting as principal. This was often intended to simplify the legal relationship of the parties. It did not usually do so.

As a matter of contract law parties can often agree that facts should be deemed to be different from what they are in reality. As between the two parties to a particular agreement this has the desired effect. However, such a fiction cannot usually alter reality so far as third parties are concerned. If one party to a contract is an agent, an agreement between him and his

counterparty to pretend that he is a principal will not normally be effective to alter the legal rights of the real principal for whom is he acting.[1] The use of "principal-to-principal" standard agreements when one party is a fund manager often fails to simplify the relationship. It may instead cause uncertainty.

Sometimes a master agreement is signed which wrongly records that both parties act as principal, because the market counterparty insists on using a standard form drafted in this way. In an attempt to clarify its position, the fund manager may send to its counterparty a letter recording that it will always be acting as agent. This practice is almost equally undesirable. It gives rise to arguments about the timing of the letters and disputes as to which of the conflicting terms prevail. It also produces uncertainty because (almost always) it fails to deal with consequences which follow from the agency status. For example a clause in the "principal-to-principal" agreement purporting to allow set-off of all obligations will clearly be inapplicable where one party is an agent, but may not be specifically cancelled by the fund manager's letter.

It is unwise for parties to use documentation which misdescribes their relationship. A belief that this simplifies matters is mistaken. This is now recognised, and standard market documentation has begun to address the issue. For example, the standard agreement intended for use in the new Gilt Repo Market will provide for certain trades to be designated as agency transactions when one party is not acting as principal and will set out the consequences of this.

We strongly recommend that the master agreements between fund managers and market counterparties should record clearly the circumstances and capacity of the parties.

Dual Capacity

Fund managers are often part of a larger financial institution, such as a commercial banking group. Usually in UK practice the fund management arm is separately incorporated and the

---

1 There may be situations where the principal has acquiesced in the fiction that his agent is actually a principal, and would thereafter be prevented from asserting that this fiction was incorrect.

legal entity concerned carries on no other business. In particular, it does not run a trading book[1], any proprietary trading being transacted by a separate group company (which might itself be a client of the fund manager).

The segregation of activity has two benefits:

(i) the single capacity of each company involved makes it easier to document its activities clearly; and

(ii) it helps control potential conflicts of interest. If a fund manager trades sometimes for clients and sometimes for itself, there may be a concern that it can abuse the trust of its clients by allocating to itself assets which appreciate in value and to clients assets which decline. Proper business practice and regulatory rules do, of course, prohibit this practice.[2] Nonetheless the best way to make it clear that front-running will not happen is for the fund manager not to trade for its own account at all.[3]

However, there are some organisations which, for cogent commercial reasons, act as fund managers within a corporate entity which carries out other activities as well. This is the case, for example, with some banks incorporated in civil law jurisdictions, which do not have the tradition of separate incorporation found in common law countries. In other cases, the use of a single trading entity may be dictated by the terms of a double-tax treaty between the UK and the state of incorporation of the entity concerned. It is possible by the adoption of correct contractual arrangements and internal organisation to achieve clarity in the operations of a dual-capacity company. However, legal transparency and certainty will be assisted by the adoption by fund managers of the principle of single capacity.

---

1 Defined in the Capital Adequacy Directive (Council Directive 93/6/EEC) to cover "own account" positions held by the institution concerned.

2 See, for example, SIB Core Conduct of Business Rules, rule 24.

3 This does not, of course, eradicate the potential problem of unfair allocation between clients.

Draft Clauses

Set out as paragraph 2 in the Appendix to this paper is suggested wording for incorporation into standard forms of master agreement between a fund manager and its market counterparty. The clause is intended to make it clear that the fund manager is acting as agent for others and has no liability on the contracts it concludes (unless it agrees that it is itself the principal). In addition:

(i) the draft assumes that the wording which deals with unallocated trades (paragraph 4 of the Appendix) is also incorporated. If that paragraph is not included, the drafting will not provide for the fund manager to deal without having already and finally allocated the trade; and

(ii) the drafting provides that the dealings on behalf of individual clients are to be regarded as made under separate agreements between the counterparty and each client (paragraph 2(c) of the Appendix). The separate identification of the transactions which relate to each client should in most circumstances permit the counterparty to look at its exposure to each of the individual underlying clients (ignoring the involvement of the manager) on a net basis. This assumes, of course, that the master agreement in which the paragraph is incorporated itself contains provisions for netting the obligations between the client and the counterparty in appropriate circumstances.

The draft includes optional wording to be used where the fund manager might trade for its own account as well as for clients. It is provided that the fund manager will be liable as principal only if it states that it is acting as such at or before the time of trading. This is echoed in the draft clause dealing with unallocated trades, which provides that it will apply (and that the fund manager will allocate to a client) unless the fund manager has said that it is a principal. The consequence is that, if the fund manager is actually a principal, but does not say so, the same contractual consequences flow as if it were dealing for clients ahead of allocation. The rationale is that, unless the counterparty is told that the fund manager is acting on its own account, it will assume that its credit risk is the unidentified client. It is sensible that the drafting should reflect that expectation.

If, exceptionally, the fund manager is an entity which is known often to contract as principal, this drafting should be considered closely. If in reality the counterparty will assume that the fund manager is its credit risk, unless it is told to the contrary, it should consider changing both this clause and the unallocated trades clause to provide that the fund manager will be liable as principal, unless it states that it is not so acting.

It must be appreciated that the paragraph is drafted in its widest form. It does not provide, for example, that all clients should be identified to, and accepted by, the counterparty. This reflects the market reality that trades are often struck on behalf of clients who are unidentified. It follows from this that the counterparty is not able to monitor the creditworthiness of the client, or to take action if the client's standing deteriorates. To deal with this, the paragraph includes provision that the fund manager should pass on to the counterparty any information which it has, and which casts real doubt on the client's ability to perform its obligations.

CHAPTER 4
CAPACITY AND AUTHORITY

When a fund manager, acting as agent, arranges a trade with a market counterparty, the counterparty will always be concerned to know that the fund manager's client on whose behalf the trade is arranged is contractually bound to effect settlement of the transaction.

There are three separate questions all of which may be described as relating to the legal power, or *vires*, to create the contract. Those questions are:

(i) whether the client has the legal capacity to enter into the transaction;

(ii) if it has, whether it has the legal capacity to authorise the fund manager to act as its agent in that transaction; and

(iii) if it has, whether the fund manager has in fact been authorised to act.

A variety of ways of dealing with these questions is used in the market. An analysis of the kinds of clauses found in the terms of business between counterparties and fund managers shows that there is no standard wording used to address the issue of the legal power of the client and the fund manager and the contractual terms used vary widely in their strength. Thus, in some instances the counterparty will conduct its own due diligence on the client, analysing its documents of constitution and following all other lines of enquiry that the counterparty thinks appropriate, and receiving no contractual comfort or support from the fund manager. In others, the fund manager will warrant to the counterparty that the client is empowered and has properly and effectively delegated authority to the fund manager and the counterparty will transact on the strength of that warranty alone.

The Panel's involvement in this issue arises because, even after the fund manager and the counterparty have decided commercially how the question of *vires* should be addressed and how they should allocate the risks involved between them, substantial areas of uncertainty remain. Dealing in the documentation with the three questions set out above is a difficult task and one which in practice is sometimes carried out without the detailed care which it requires.

It would be unhelpful to suggest a standard approach to be applied across the wide range of transactions and of relationships between fund managers and counterparties. The choice of approach is a commercial matter for the parties. However, there is merit in identifying the contractual solutions which are adopted most often in practice and in recommending a standard approach to the documentation of each of those solutions. Thus, when parties have decided on the contractual position suited to their transaction, they will have to hand wording with which they are familiar to implement their agreement.

It had been suggested that the first step in addressing the three questions should be for the counterparty to require, or to obtain for itself, a legal opinion as to the client's legal powers. This was a counsel of perfection: it would not, we were convinced, be practical for fund managers always to seek a legal opinion for each of their clients, nor to delineate categories of clients for whom legal opinions should be considered appropriate. Nor would the issues of reliance on and liability for such opinions be easy to resolve, especially in a market where clients' powers often fall to be determined in accordance with a foreign system of law.

The consensus among fund managers and counterparties was strongly that the matter should be dealt with between the parties to the contract, by allocation of risk between them, based on a series of terms under which the fund manager either accepted responsibility for the existence of relevant powers, accepted such liability on specific terms, or excluded the liability. Between complete acceptance and total exclusion there is an infinite capacity for nuance. However, our suggestion is that one position should be selected between the two extremes and adopted as a standard "middle course".

This paper therefore proposes a selection of three clauses which are set out as paragraph 3 of the Appendix. We recommend that one of these be chosen for inclusion in the terms of business

that obtain between counterparties and fund managers, according to the wishes of the individual parties.

It should be said that in practice the counterparty will know that some, at least, of the fundamental elements relating to the powers of the fund manager and his client have been addressed by the fund manager. In particular, the obligations placed on the fund manager by regulatory rules to "know his customer"[1] and by money laundering regulations[2] to make appropriate enquiries give considerable comfort in practice.

It is necessary first to discuss further the types of legal power that the suggested clauses seek to address.

The Three Kinds of Power

(a) Client's Power to Contract with the Counterparty

The fundamental question is whether the fund manager's client has the legal ability to enter into the contract with the counterparty which the fund manager proposes to make, as agent of the client.

For all clients (other than individuals) there is the question whether an investment transaction of the relevant type is within the powers (in particular, the investment powers) of that organisation. The majority of clients of fund managers have powers which are prescribed by words: thus, the investment powers of a pension fund are set out in its trust deed or rules, the powers of a local authority are set out by statute, the powers of a company incorporated under the Companies Acts in its memorandum and articles. In each case those powers will or will not cover the type of investment transaction that is being proposed. In a number of circumstances the wording may be ambiguous or difficult to construe or (particularly in the case of some

---

1 See, for example, IMRO Conduct of Business Rules, Chapter II: Section 3.1 ("Suitability").

2 The Money Laundering Regulations 1993 (SI 1993/1933).

overseas bodies) the powers may be affected by other legal provisions outside the relevant document. In these cases a view may have to be taken on whether particular transactions are included or excluded by the wording.

There is, however, a second facet of legal power relevant to some classes of client, which only arises as a question to be considered where the first test has been passed. This second question is: if the powers are included in the governing statute or document of constitution, are the powers being validly exercised? In relation to bodies drawn from the UK public sector, for example local authorities, the decision to enter into a transaction which is within the powers of the public body may nevertheless be challenged because the decision has been taken for improper purposes. Again, in relation to a trust (for example a pension fund scheme) the decision to make a permitted investment may have been entered into by the trustees in an invalid way (for example the trustees may have ignored a particular decision-making procedure required by the trust deed).

Contractual clauses must cover both facets of the question of legal power discussed here.

(b) Client's Power to Appoint the Fund Manager

The second aspect of *vires* which needs to be covered is to ensure that the client, in addition to having the legal power to enter into the contract concerned, has the power (in the case of a discretionary client) to delegate to the fund manager the function of deciding to enter into the contract and has the power to appoint the fund manager the agent of the client for the purpose of concluding the contract concerned.

In practice, the latter of these two limbs is not usually a problem: most jurisdictions recognise very wide powers for legal entities to appoint agents to contract in their name. The former can, however, require some care. There are some circumstances (for example where the client is trustee of a pension fund) where the relevant governing system of law may limit the circumstances where the power (and responsibility) to make investment decisions may be delegated. The power to delegate discretion should not be taken for granted.

(c) Fund Manager's Specific Authority

Finally, contractual terms about *vires* need to address the question whether, given that the client has power to contract and power to authorise the fund manager to act as its agent, the client has in fact appointed the fund manager to enter into the contract on its behalf.

At first sight, the question seems to answer itself: no responsible fund manager would purport to contract binding obligations on behalf of its client unless it had been authorised to do so. However, the position is not always very clear. Frequently, a fund manager will be given authority to act only within specific confines. For example, it might be given discretion to buy securities, but only provided that non-UK equities did not account for more than 50% of the portfolio by value. With shifting values for the constituent shares in the portfolio, it is possible that the fund manager's authority could be exceeded inadvertently.

All competent fund managers, of course, have systems to prevent this happening. However, it remains a possibility which needs to be covered contractually.

Alternative clauses

The risk of inadequate *vires* may be allocated so as to fall wholly on the shoulders of the counterparty, wholly on the shoulders of the fund manager, or somewhere in between. Whilst there are conceptually a great many stations on that range of allocation of risk, it would not be useful or constructive to recommend a selection of more than three: that the fund manager should take all the responsibility, that the counterparty should take all the risk, or that a middle position should be agreed. The middle position we recommend is a warranty by the fund manager that he "reasonably believes" his client to have the necessary legal powers, the precise effect of which is discussed below.

In paragraph 3 of the Appendix we set out the wording of the three alternative clauses whose use we recommend. For the purpose of discussion, their effect can be summarised as follows:-

A The fund manager warrants that transactions with the counterparty arranged by the fund manager will constitute legal, binding and enforceable obligations of the fund manager's client.

B The counterparty agrees that the fund manager gives no warranty about and has no liability in respect of the client's ability or power to enter into the transaction, the ability of the client to appoint the fund manager to act for the client, or the validity of the actual appointment.

C The fund manager warrants that he reasonably believes that transactions with the counterparty arranged by the fund manager will constitute legal, binding and enforceable obligations of the client.

Clause A provides the counterparty with a right against the fund manager in damages (for breach of warranty) if transactions arranged by the fund manager are not binding on the underlying client. It should be pointed out that the giving of a warranty by the fund manager of this type does not constitute the giving of a guarantee, nor of an indemnity. The amount of damages for which the fund manager would be liable in the case of breach will be assessed in accordance with normal legal principles.

Clause A encompasses all three of the *vires* questions discussed above. If it is correct that a binding contract exists, it must follow that all three questions are answered affirmatively.

Clause B reverses the situation and makes it clear that the fund manager cannot be sued for breach of warranty if the transaction is arranged by the fund manager on behalf of a client who does not have the necessary legal power to enter into that transaction, or to appoint the fund manager, or if there is a defect in the appointment itself. It should be noted that clause B is not drafted in such a way, however, that it would protect a fund manager who knowingly sets out to deceive a counterparty by arranging transactions that cannot be completed. Further, the clause excludes any liability that might flow from an *implied* warranty that the fund manager had authority to bind the client.

Clause C introduces a notion of reasonableness. The fund manager warrants that he maintains a belief that the transactions concluded on the client's behalf are *intra vires*, that his appointment as fund manager is capable of being valid and that the appointment is also valid in fact. The fund manager also warrants that it is reasonable for him to maintain that belief (or, which is the same thing, that a reasonable fund manager would hold the same belief). The first limb might be described as subjective, the second as objective. Whether the belief is genuinely held is a matter of fact alone; whether it is reasonable is a mixture of fact and law. We deal below with matters which may be relevant as helpful guidelines in assessing whether a court is likely to find a belief reasonable. It should be stressed, however, that what is reasonable will turn in each case on the particular facts under consideration and that it is unlikely that any one test for what type of belief is reasonable will ever be formulated.[1]

There will be circumstances where the inclusion of the word "reasonable" has little effect on the extent of assurance being given by the fund manager. In some circumstances, especially where the person giving the warranty is likely to have information which is not available to the counterparty (the most obvious example being where the fund manager has not disclosed the identity of its client) a statement that a particular belief exists (whether or not the person making the representation states that his belief is reasonable) may carry with it an implied representation that the maker of the statement has taken reasonable steps to ascertain what the true position is[2].

Guidelines as to reasonableness of belief

The factors relevant to the assessment of whether a genuinely held belief in a client's legal powers or the validity of their exercise is reasonable may include some of the following matters.

---

1 Almost all fund managers are structured as limited companies: the "belief" held at any moment by a company will be the conglomerated beliefs of its officers and representatives (and, if applicable, agents).

2 In the context of the sale of land, see *William Sindall plc v Cambridge County Council* [1994] 3 All ER 932.

It cannot be stressed too strongly, however, that the following list is for guidance only and is not exhaustive. What is reasonable will be determined by a judge applying common sense in the context of the transactions under consideration.

The most significant factor in assessing whether a belief held by a fund manager is reasonably held will often be the amount of information on which the belief is based. The sources of this information will include:-

* Things which are already common knowledge within the relevant part of the fund management industry, for example that clients who are individuals not acting in a trustee capacity have unlimited powers of investment.

* Some information is known generically about certain types of client, for example that the use of swaps by UK local authorities will often be *ultra vires*.

* That transactions of an identical type for the same client have not been challenged in the past might be a relevant piece of information.

* Information gained from enquiry of the client[1]. For different types of client, enquiry of different depth may be thought appropriate. Enquiries may include any of the following: meeting the representatives of the client and discussing proposed investment activity with them, posing the question whether those transactions will be within the client's powers, inspecting the constitutional documents of the client, arranging for the client to provide a legal opinion or even the fund manager commissioning a legal opinion of its own.

* Particular importance must be attributed to the fact that a fund manager who warrants a reasonable belief may be basing his belief on information gained from meeting the

---

1 An IMRO member will be required in any event to seek any information which might reasonably be expected to be relevant in enabling the IMRO member to fulfil its responsibilities to the client (IMRO Rules Chapter I, Section I, Principle 4).

representatives of the client, the way in which the client institution became introduced to the fund manager and other imponderables. These factors cannot be set down in precise language, but should not be overlooked. There will be circumstances where it is reasonable to base a belief entirely on what has been said by seemingly honest people. Sometimes it may be reasonable to base a belief in whole or in part on a warranty from the client as to its own legal power to transact and/or delegate.

The reverse side of this coin is that a belief may be genuine, but held in ignorance of facts which would show it to be unfounded. It must be doubtful whether a belief can be said to be reasonable if the fund manager has deliberately avoided making enquiries or reading documents which would have shown the belief to be false and which a conscientious fund manager might have made or read.

It will be clear that within the three alternatives set out there is scope for further refinement. It is possible, for example, to exclude from the scope of the warranty categories of client seen as particularly sensitive, or to provide for the consequences of a breach of whichever warranty is chosen to be applicable, or to seek additional warranties not dealt with within this paper. One sensible way of moderating or dictating the scope of the warranty as to reasonable belief will be to adopt a practice that already exists in the market, namely to set out in writing (either in the main agreement or in separate correspondence) the types of due diligence work that are routinely carried out by the fund manager, and types which are not. Thus, to take an example, fund managers may say that documents constituting the client body (articles of association, pension scheme deeds, statutory provisions and regulations and so forth) will not have been inspected, or that a warranty has been obtained from a representative of the client fund to the effect that the necessary capacity exists and that the fund manager will rely on the accuracy of that statement. Or the counterparty may state in writing assumptions being made about what diligence the fund manager routinely carries out[1]. These are, of course, only examples. They have the effect of making clear, as between the parties, the factual background against which

---

1 Some counterparties go further, and visit fund managers with whom they propose to deal in order to inspect and investigate the fund manager's procedures and systems for establishing, amongst other things, a fund manager's clients' legal powers.

each of them understands the word "reasonable".

In general, any information about the capacity of the client or about the steps taken to establish whether that capacity exists will inform the meaning of "reasonable belief". A fund manager who maintains that no stone is left unturned in carrying out investigations and who warrants that he reasonably believes the necessary legal capacity to exist, gives an assurance tantamount to a guarantee; one who expressly states that he has taken no special steps but who nonetheless represents that he "reasonably believes" that his client has power gives an assurance of significantly weaker effect.

The Financial Law Panel has no intention of recommending which of the three clauses should be used, nor to promote any variation of any one of those clauses. Each clause attempts to lodge the risk in a different place and the choice of that place and the precise wording is - and should be - a function of the market.

CHAPTER 5
UNALLOCATED TRADES

It is in the nature of institutional fund management business that a fund manager often deals in the market for a number of its clients collectively. Some fund managers (but by no means all) also deal for their own account as part of such an aggregated trade. This practice is well understood and accepted by regulators, subject to safeguards[1]. Indeed, the economies of scale it permits often reduce dealing costs for clients.

However, when a fund manager arranges a trade with a market counterparty intending to act as agent on behalf of its clients, but at the time of arranging the trade the fund manager has not allocated that trade to one or more of its clients, the legal consequences of the fund manager's intended agency are uncertain.

The situations that could give rise to problems are of two main kinds: aggregated trades and partly-satisfied bids. In an aggregated trade, typically, the fund manager arranges a transaction with a counterparty for securities or foreign exchange, informing the counterparty that it is acting only as agent for clients, but not yet having allocated the contract among the several funds under management. In the case of a partly-satisfied bid, the fund manager places a bid for an amount of securities with a counterparty on, for example, a new issue. He bids on behalf of clients and may already have allocated those securities to clients. However, he receives fewer securities than the total number bid for. The securities which are confirmed to him by the issuer must then be allocated or (if an allocation has already been made) must be re-allocated among the fund manager's clients. This re-allocation process might involve fresh decisions by the fund manager. For example, the clients' investment parameters may not permit the allocation of the smaller amount that would result from a pro rata apportionment.

---

1 See the schedule to this chapter.

The legal problems for fund managers of dealing before allocation (or re-allocation) are similar in both these situations. The effect will, of course, vary depending on the facts. In practice, problems between the parties will only arise if the transaction is for some reason not settled. However the legal analysis of the position between dealing and settlement is important, for credit purposes of both parties and for regulatory purposes.

The law in this area is both complex and unsettled. There are no Acts of Parliament which marshal the law of agency and most of the cases surrounding these legal topics pre-date the mechanisms and practices of the modern financial markets. The application of agency law in the complex financial market structures which exist has yet to be the subject of judicial interpretation. Perhaps for this reason, the problems associated with dealing ahead of allocation tend in the overwhelming majority of cases not to be addressed in the terms of business effected between fund managers and their counterparties. The result is that fund managers frequently contract on terms which, when analysed in relation to the law applicable to agency, may give rise to legal consequences which are unintended and, in some cases, unfortunate.

The Panel's Involvement

At the end of 1993 the Financial Law Panel circulated within the industry its private paper, "Legal Uncertainties in Fund Management"[1], that dealt with this area by setting out a number of hypothetical, but typical, situations and analysing the rights and liabilities that flowed from them. That paper was intended primarily to assist discussion between fund managers and counterparties. There was general agreement that the uncertainties should be addressed and that the most effective way to achieve this would be to recommend a form of wording which would eliminate the otherwise unfortunate legal consequences, if adopted as part of the terms of trade between a fund manager and its counterparty and followed in practice.

To that end, a number of alternate legal mechanisms were considered and wording drafted which provides for the mechanism felt to be most appropriate. We recommend that market participants should consider this wording in detail, with a view to its inclusion in the terms of

---

1 Copies of the paper are available on request from the Panel.

business that apply between counterparties and fund managers. It is set out as paragraph 4 in the Appendix and considered further below.

Undisclosed or Unnamed Clients

The Panel's paper "Legal Uncertainties in Fund Management" dealt in some detail with the problems of agents and principals and their dealings with third parties in the financial markets. The paper pointed out that, when a fund manager deals in the market before final allocation has taken place, the legal consequences can be unclear both for the manager and for his underlying clients:

(a) **The clients**

The underlying clients, at the time of the fund manager's dealing, will not be in contractual relations with the counterparty. The legal mechanisms of ratification, novation and assignment, the operation of which would produce the desired contractual link, will probably not be available here.

(b) **The fund manager**

The counterparty may allege that the fund manager is liable on a contract collateral to the main contract (the crux of which would be the fund manager's obligation to see to it that a suitable counterparty did indeed exist). More likely, there may be a right of action against the fund manager for breach of warranty of authority. That is to say, where a fund manager makes an arrangement with a counterparty, purportedly as agent, but the fund manager in fact has no principal, the implied warranty that he is duly authorised to act as agent may be said to have been breached.

It is not suggested that any of these conclusions are certain, merely that they illustrate the existence of legal difficulties that should be addressed.

The Regulatory Position

The practice of fund managers dealing ahead of allocation is recognised in the SIB Core Rules and regulated under the IMRO Rules and SFA Rules. The word "allocation" is not defined. In practice it is understood to mean the decision by the fund manager, acting within its mandate from a client, that the client should be the principal in a contract with a counterparty. There is no regulatory requirement that details of an allocation (or even the fact that it has happened) should be communicated to the counterparty. A fund manager is, however, obliged to allocate promptly and fairly and to record without delay allocations made. The relevant rules are set out more fully in the schedule to this chapter.

The Recommended Provision

The Panel's working group considered a number of ways of addressing the problems outlined above. The conclusion was that the uncertainties did not spring from any incapacity of contract or agency law to deal with the situation clearly, but from the failure of documentation used in the market to state clearly the way in which the parties wished to regulate their dealings. It should be possible, therefore, to draft wording which sets out a mechanism under which these uncertainties are resolved and which can be used, with appropriate adjustment for specific circumstances, as a market standard.

The provision does not apply where the trade is made by the manager *after* it has allocated to a client or clients. In this case the legal relationships are clear, whether or not the client is identified and even if the existence of a client is undisclosed. Nor does it apply, obviously, where the manager has said in advance that it is acting for its own account.

The paragraph can, in practice, be expected to apply in only one situation: where the manager trades, not yet having finally decided how responsibility will be allocated between its clients (and possibly the fund manager itself). However, the clause would also operate in the unlikely situation where the fund manager traded for its own account, but did not tell the counterparty. In that case it would leave the manager with a potential liability in damages, if it did not settle the trade (because it would be in breach of its obligation to allocate). The financial cost to the

fund manager of breaching this obligation would be likely in practice to be the same as that it would suffer, if it breached an obligation to settle the trade.

The paragraph has at its heart an undertaking by the fund manager to allocate the trade and an agreement by the counterparty to be bound to transact with the fund manager's client when allocation to that client has happened. The client becomes bound to the trade at the moment of allocation. The parties must agree whether that occurs at the point of decision by the manager - so that it is entirely internal to the fund manager - or at the moment of his identification to the counterparty. The respective obligations that arise when a trade has been arranged, but not yet allocated, are thus as follows:-

(a) The counterparty's obligation is to deliver (or, as the case may be, take delivery of) the subject-matter of the trade to or from the client or clients (including perhaps the manager itself), who are to be identified by the fund manager at a later date.

(b) The fund manager does not have an obligation to complete the original deal, only to nominate *someone* who will then have an obligation to complete it. The damages for which he will be liable if he breaches this obligation will, in practice, be the same as those for breach of an obligation to complete the original deal.

One important factor is the variation in market practice of the extent to which fund managers' clients are named to counterparties and it is necessary to achieve a formulation that creates the required legal effect both where the clients are named, and where they are not. This is achieved by the inclusion of an option in the definition of "allocate" of a requirement that the manager notify the counterparty of the identity of the clients to whom the trade has been allocated. It is a matter for commercial decision between the parties whether this option is taken, or whether allocation is complete, even if the counterparty is not told that it has happened.

A further option allows the parties to restrict the definition of "client" by reference to specified characteristics (eg a client must be a UK pension fund with assets of more than £100 mn). Thus, although the counterparty does not know the identity of the contractual party to whom it will become bound, it can be sure of the class of entity to which it belongs.

Even if the identification option is chosen, it does not follow that the full name of the client must be disclosed. The wording caters for three degrees of identification. In the first, the fund manager names the client. In the second, the fund manager uses a code previously agreed. The fund manager will tell the employee of the counterparty with whom he is dealing the code name of the client, agreed between the manager and the counterparty at an earlier stage. This method provides certainty of identification, whilst preserving a degree of confidentiality. Third, the mechanism allows the fund manager, if so agreed, to use a code which, although it identifies the client clearly within the manager's organisation, does not permit the counterparty to know anything other than the fact that an unnamed principal does indeed exist and is identifiable from the records of the fund manager. A variation on this position would be a code which identified a client as being within a particular category. For example, the parties might agree a codification system where the code name used did not identify the client, but indicated to the counterparty that it was a UK corporate pension fund.

The recommended paragraph only addresses the problems of dealing ahead of allocation. In practice these problems are not addressed in isolation and in negotiations between counterparties and fund managers other issues, in particular creditworthiness and legal capacity, are considered at the same time. The relative importance of these factors varies. The Financial Law Panel's view is that the moderation of these factors is a function of the market and it is not our concern to impose allocations of risk on areas which market forces should decide.

SCHEDULE

The regulatory position

Securities and Investments Board

1 SIB Core Conduct of Business Rules, rule 23

"Timely Allocation

A firm must ensure that a transaction it executes is promptly allocated."

2 SIB rule 24

"Fair Allocation

Where a firm has aggregated an order for a customer transaction with an order for an own account transaction, or with another order for a customer transaction, then in the subsequent allocation:

a it must not give unfair preference to itself or to any of those for whom it dealt: and

b if all cannot be satisfied, it must give priority to satisfy orders for customer transactions unless it believes on reasonable grounds that, without its own participation, it would not have been able to effect those orders either or on such favourable terms or at all."

Investment Management Regulatory Organisation

1 IMRO Rules Chapter II: Section 3, rule 3.9(1), ("Timely Allocation") reproduces rule 23 of SIB Core Conduct of Business Rules.

IMRO guidance to rule 3.9(1) states:

"Where a Member has dealt collectively for Customers, or for one or more Customers and itself, allocation of the transaction should be completed as soon as possible after the transaction is effected."

2 Rules 3.9(2)-3.9(6) expand on the general rule and its application in cases where transactions are effected as part of a series and make provision for the consistent recording of allocation decisions.

3 IMRO Rules Chapter II: section 3, rule 3.10(1), ("Fair Allocation") reproduces rule 24 of SIB Core Conduct of Business Rules.

4 Rules 3.10(2) and 3.10(3) deal with allocation price and require that managers maintain uniform procedures for allocation.

The Securities and Futures Authority

Although the great majority of fund managers are members of IMRO, rather than SFA, banks or securities houses where fund management business constitutes only a minor part of their business may avoid duplication by having that business supervised by SFA.

1 SFA Rules Chapter 5: rule 5.40(1) ("Timely allocation") reproduces rule 23 of SIB Core Conduct of Business Rules.

2 Rule 5.40(2) provides:

"The allocation must be:

(a) to the account of the customer on whose instructions the transaction was executed;

(b) in respect of a discretionary transaction, to the account of the customer or customers with or for whom the firm had made and recorded, prior to the transaction, a decision in principle to execute that transaction; or

(c) in all other cases, to the account of the firm."

It is, it will be noted, more restrictive than the corresponding IMRO Rule, since it requires that, for a transaction to be capable of allocation to a client, a decision to execute *for that client* must have been taken in principle before trading.

3 Rule 5.41 ("Aggregating orders") provides:

"A firm may aggregate an order for a customer with orders for other customers, or with own account orders, where:

(a) it is unlikely that the aggregation will operate to the disadvantage of any of the customers whose orders have been aggregated; or

(b) the firm has disclosed to the customer that his order may be aggregated and that the effect of the aggregation may operate on some occasions to his disadvantage.

Guidance

A firm should only aggregate customers' orders where it believes on reasonable grounds that this is in the overall best interests of its customers."

4 Rule 5.42 ("Fair allocation") reproduces rule 24 of SIB Core Conduct of Business Rules.

APPENDIX
Draft Agency Terms

The following draft provisions are constructed as a separate and self-contained schedule to a customer agreement between the fund manager (called "the Manager") and its market counterparty (called "the Bank"). The terms will need adjustment according to the form and nature of the document into which they are incorporated, in order to make them comply with the substance and drafting of that document. This is a task which should be undertaken only by appropriately experienced lawyers.

It is assumed that the document into which the terms will be incorporated will be governed by English law.

Schedule of Agency Terms

Definitions

1 In this schedule:

(i) "client" means a person, body of persons, a company or any other entity (whether or not it has a separate legal personality) on whose behalf the Manager acts or claims to act in relation to one or more transactions concluded hereunder, and which may be an associate of the Manager. *[A client shall at the time of allocation have the characteristics and conform to the criteria set out in writing by the Bank to the Manager referring to this agreement, as amended from time to time;]*[1]

"Settlement Date" means in relation to each Trade the first time at which any obligation (whether for the payment of money, delivery of securities or otherwise) falls to be performed by any party;

"Trade" means a transaction, the terms of which are agreed between the Bank and the Manager with the intention that, upon allocation, those terms should form a contract (or contracts) between the Bank and a client (or clients). Where part of the benefit of such a transaction is (i) for the account of one or more clients determined by the Manager before the time of such transaction (whether or not made known to the Bank at the time); or (ii) for the account of the Manager and where this fact and the part of the transaction involved have been specified to the Bank at the time of the transaction, then "Trade" means the transaction excluding such part or parts; and

"Trade Date" means in relation to each Trade the time at which the terms of the Trade are agreed;

(ii) the Manager "allocates" a Trade (or part of a Trade) to a client (an "allocation") when it decides that, as between the Manager and the client, the Trade (or part of the Trade) is for the account of the client *[and the Manager identifies the client as being responsible for the Trade (or part of the Trade);* and

(iii) the Manager "identifies" a client if (but only if) it notifies the Bank in writing of:-

(a) the name and (unless the Bank shall agree that it is unnecessary) address of the client; or

(b) if the Bank and the Manager shall have agreed before the Trade Date a code name for such client, that code name; or

(c) if the Bank and the Manager shall have so agreed before the Trade Date, a code name or number used in the records of the Manager to refer uniquely to such client].[2]

Capacity in which the Manager Acts

2 (a) *[The Manager may enter into transactions with the Bank under this agreement for its own account or as agent. If the Manager states at or before the time when the transaction is agreed that the transaction is made wholly or partly for its own account the Manager will be liable to the Bank as principal in respect of the specified part of such transaction. The terms of this paragraph are without prejudice to the liability of any person other than the Manager in respect of the relevant transactions.*

Except to the extent that the Manager so states that it is acting for its own account.][3] every transaction under this agreement will be concluded by the Manager as agent for a client or will be deemed to have been so concluded as set out in paragraph 4(c) of this schedule. Accordingly the Manager shall not be liable as principal to perform the terms of any such transaction, but this is without prejudice to any liability of the Manager under paragraph 4(b) of this schedule or any other term of this agreement.

(b) If the Manager becomes aware of facts which in its view indicate that it is likely that a client will fail to carry out any of the material terms of any contract between the client and the Bank made hereunder, it will inform the Bank and will provide the Bank with such additional information as the Bank shall reasonably request.

(c) The terms of this agreement (other than this paragraph 2) shall apply in relation to each client as if a separate agreement had been executed between the Manager and the Bank in respect of all transactions concluded on behalf of such client.

Power and Authority to contract[4]

3 (Manager accepts Responsibility)

[The Manager warrants to the Bank that on each occasion when the Manager makes or purports to make a contract with the Bank on behalf of a client or is deemed to have done so as set out in paragraph 4(c) of this schedule the terms thereof will (i) constitute the valid and binding obligations of the client concerned; and (ii) will be enforceable against such client, subject in each case only to such reservations and qualifications as would apply irrespective of the identity or circumstances of such client or the terms of its relationship with the Manager.]

OR

(Manager excludes Responsibility)

[The Manager makes no representation[5] to the Bank, and excludes any implied representation or warranty in relation to:

(i) the legal power or capacity of any client to enter into any contract with the Bank or to perform any of the terms thereof;

(ii) the legal power or capacity of any client to enter into any contract with the Manager (whether or not in writing) pursuant to which the Manager purports to act on behalf of such client; or

(iii) the existence, validity or enforceability of any authorisation by any client pursuant to which the Manager purports to act on behalf of such client;

and shall in no event, other than deceit on the part of the Manager, have any liability to the Bank arising out of lack of or defect in the capacity, legal power or authorisation of any client or of the Manager.]

OR

(Manager warrants its Reasonable Belief)

[In relation to each contract between the Bank and a client which the Manager makes or purports to make on behalf of the client, or is deemed to have made as set out in paragraph 4(c) of this schedule, the Manager warrants that it will, at the time when the contract is made or purported to be made or deemed to be made, reasonably[6] believe that:

(i) the client has all requisite power and legal capacity under the laws of the relevant jurisdictions to enter into the contract with the Bank through the agency of the Manager and to perform its obligations; and

(ii) the Manager had been duly authorised to enter into the contract on behalf of the client.]

Unallocated Trades

4 (a) This clause shall not apply in respect of any transaction between the Manager and the Bank to the extent that, at the time when the transaction is agreed, the Manager (i) is acting as agent for a client or clients (whether or not identified) to whom the transaction has already been allocated or (ii) has indicated to the Bank that it is acting for its own account.

(b) The Manager undertakes that it will allocate each Trade before the Settlement Date either to a single client, or to several clients each of whom will be responsible only for that part of the Trade allocated to it. The Manager shall not be liable as principal to perform the terms of any Trade.

(c) Upon allocation of a Trade (or part of a Trade), a contract on the terms of the Trade (amended as necessary where part only is allocated) shall be deemed to have been made with the Bank with effect from the Trade Date by the Manager on behalf of the client concerned.

(d) If the Manager shall fail to perform its obligations under sub-paragraph (b) above then for the purpose of assessing any damage suffered by the Bank (but for no other purpose) it shall be assumed that, if the Trade concerned (to the extent not allocated) had been allocated in accordance with such sub-paragraph, all the terms of the Trade would have been duly performed.

---

1 This should be deleted if the Bank is prepared to deal with all clients of the Manager, whoever they may be.

2 This wording should be included if the Bank is not prepared to enter into direct contractual relations with a client of the Manager unless the client is identified. Note that the paragraph does not give the Bank the right to veto allocation to a particular client on identification.

3 These words may be deleted if the parties are sure that the Manager will *never* act for its own account. If the Manager usually acts as principal, this schedule may in any event be inappropriate.

4 The three forms of warranty are alternatives. When the parties have decided which of the three possibilities matches their agreement all other words in the paragraph should be deleted.

5 Contracts relating to the creation or transfer of securities or of any right or interest in securities fall outside the Unfair Contract Terms Act 1977 (Schedule 1(1)(c)). There may be transactions, however, to which that Act applies so as to make attempts to exclude liability for misrepresentation subject to the test of reasonableness.

6 Whether a belief is held "reasonably" will depend on the facts. It is strongly recommended therefore that parties should establish between themselves an understanding of the due diligence procedures which the fund manager will carry out in order to be able to give this warranty.

We would like to thank the following people
who served as members of the working group:-

Laurie Adams - Citibank NA

Derek Councell - Prudential Corporation plc

Lucinda Evans - BZW Investment Management Limited

Charles Farquharson - Mercury Asset Management plc

Jeffrey Golden - Allen & Overy

Jennifer Goodwin - Union Bank of Switzerland

Stephen Greene - Credit Suisse Financial Products

Harold Haden - M&G Group plc

Professor Robert Jack - Scottish Mutual Assurance Society

Dr Lorraine Newbold - BZW Limited

John Parsloe - Mercury Asset Management plc

Catherine Roberts - Erskine Chambers

Gerard Scully - Swiss Bank Corporation

Neil Stocks - Swiss Bank Corporation

Richard Sykes QC - Erskine Chambers

Stephen Tanner - Institutional Fund Managers Association

Howard Trust - Barclays Bank plc