

# Article

## **Information Disclosure, Risk Trading and the Nature of Derivative Instruments: From Common Law Perspective**

**Chao-Hung Christophe Chen\***

### ABSTRACT

*This paper explores issues of pre-contractual disclosure for derivative instruments, of which this paper describes as contracts to trade risks, in the UK and US. While there is no general duty of disclosure in common law, this paper focuses on whether there should be a duty of disclosure for derivative instruments by comparing with securities law and insurance law. This paper argues that mandatory disclosure in the securities market cannot be extended to exchange-traded futures contracts (save where securities are involved) because of the nature of securities. In addition, this paper argues that derivative instruments, though similar to insurance in certain regards, lack the inequality of knowledge issue underlying contracts of insurance; and thus, derivative instruments should not be seen as another type of contract *uberrimae fidei*. However, while we cannot establish a duty of disclosure by treating derivative instruments like securities or insurance, we argue that the concepts of market abuse and insider dealing might provide a better basis for addressing information issues in the risk trading market.*

**Keywords:** *Derivatives, Duty of Disclosure, Information, Insider Dealing, Utmost Good Faith*

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\* Ph.D., University College London; LL.M., The University of Michigan Law School; LL.M., National Taiwan University College of Law; LL.B., National Taiwan University College of Law. E-mail: chaohung@mac.com.

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## I. INTRODUCTION

In this paper, we will treat derivative instruments<sup>1</sup> as contracts to trade risks,<sup>2,3</sup> and we will turn to a fundamental problem of risk trading — information and uncertainty. Risk trading relies heavily on information and there is a range of disclosure and non-disclosure rules in different legal fields. The insider dealing rule also provides another angle from which to approach potential information problems in risk trading. In light of certain disclosure rules in laws relating to securities and insurance, we might further inquire whether derivative instruments are another type of contract *uberrimae fidei* or whether the disclosure rule attaching to securities could be extended to apply to derivative transactions. From this perspective, the information problem might influence the nature of derivative instruments and might raise further regulatory issues. We will argue that neither the securities nor insurance disclosure rules are completely suitable for the derivatives market. It is arguable whether we need to create a special rule for risk trading contracts and an analysis of market manipulation might provide a better basis for accessing potential information problems in the risk trading market. The following discussion is largely based on UK Law, but certain US materials will be added for comparison.

While this paper focuses on the distinction of relevant concepts under UK law and US law, this research will also benefit readers with Taiwan law background. The arguments developed in this paper might also be applied to

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1. In general, a derivative “can be defined as a financial instrument whose values depend on (or derive from) the values of other, more basic underlying variables.” In general, a derivative “can be defined as a financial instrument whose values depend on (or derive from) the values of other, more basic underlying variables.” SATYAJIT DAS, *DERIVATIVE PRODUCTS & PRICING* 4 (3d ed. rev. ed. 2006). The umbrella term of “derivative” may refer to a wide range of financial products traded in different forms and based on a variety of underlying assets. The four general categories of derivatives include options, futures, forward contracts, and swap agreements. There are so-called hybrid (or structured) instruments that incorporate certain derivative techniques into a traditional instrument (such as bonds). Looking at the place where derivative instruments are traded, those traded on organised exchanges may be differentiated from those traded in the over-the-counter (OTC) market.

To put in short, options are rights (but not obligations) to buy or sell something in the future at a price fixed at present. In a forward contract, the buyer agrees to buy and the seller agrees to sell a specified underlying asset on a specified date at a specified price (the “forward price”). DAS, at 9. Futures contracts are forward contracts that are traded on a futures exchange. A swap is in essence an exchange of cash flows; thus, in a way a swap could be seen as a composition of forward contracts. DAS, at 83. As there are many types of derivative instruments in the market, this paper cannot explain all of them in full, but this paper will explain how a certain product operates where necessary.

2. This description is based on the two major functions of derivative instruments: hedging and speculation. On the one hand, derivative instruments help market participants to hedge against risk exposure. On the other, they also allow traders to speculate on future uncertainties.

3. In general, risk is “the chancing of negativity — of some loss or harm. ... Risk faces us with the possibility that something untoward may occur, while leaving us unable to foretell any specific outcome with categorical assurance.” NICHOLAS RESCHER, *RISK: A PHILOSOPHICAL INTRODUCTION TO THE THEORY OF RISK EVALUATION AND MANAGEMENT* 1 (1983). See also Anthony Giddens, *Risk and Responsibility*, 62 M.L.R. 1 (1999).

relevant laws and concepts in Taiwan. In addition, while the UK and the US boast the biggest derivatives market in the world, and many Taiwanese financial institutions have to conduct derivative transactions with British or American financial institutions, or have their agreements governed by English law or New York law. Thus, having understanding of the development and applicable laws in the UK and the US would be helpful to practitioners and academic researchers who have interests in derivative instruments.

## II. INFORMATION PROBLEMS IN RISK TRADING

### A. *Information and Trading*

Information problems can best be illustrated by an old American case, *Laidlaw v. Organ*<sup>4</sup> a case about a tobacco sale in New Orleans in the early 19<sup>th</sup> century. During that time, New Orleans was under blockade by the British Navy during the war of 1812 and the price of tobacco would have been higher had the blockade been lifted. When the Treaty of Ghent was signed and the news spread through Britain and Washington, people in New Orleans were still ignorant of this fact. Before the news reached other traders in New Orleans, the defendant-buyer somehow learnt the news from another person who was with the British fleet at the time. The buyer then entered into a sale agreement with the claimant and some tobacco was delivered. Soon after, news of the peace treaty was circulated and the claimant-seller felt he had been cheated, so he brought a lawsuit to stop the buyer from disposing of the tobacco that had been delivered and refused to make delivery of the rest. The issue was whether the buyer should have disclosed this important information to the seller and whether, upon inquiry by the seller, the buyer could keep silent on the issue. Unfortunately for Laidlaw, the US Supreme Court refused to impose a duty of disclosure on Organ.

Although Laidlaw was in the context of a physical sale, the same scenario could appear in derivatives trading. Had the contract between Laidlaw and Organ required delivery of tobacco three months after the conclusion of the contract, it would have become an information problem for a forward contract. On the other hand, gambling could shed some light on the speculative aspect of risk trading contracts, for if both parties in *Laidlaw* had wagered on the level of tobacco prices in the following month instead of concluding an immediate physical sale, the withholding of information by Mr. Organ might have constituted fraud or cheating.

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4. *Laidlaw v. Organ*, 15 U.S. 178 (1817).

Since trading risk deals with future uncertainties,<sup>5</sup> proper evaluation of the risk exposure relies heavily on all sorts of information. Possible impact from future risk can be better accessed if one has better knowledge and information. However, since acquiring and distributing information incurs costs and since the information itself might be valuable enough to prohibit it from being free flowing, there could be an information gap between someone who holds the information and someone else who has not been informed. In *Laidlaw*, Laidlaw did not learn the news of the Ghent Treaty because it took time for this information to arrive in New Orleans.<sup>6</sup> A lack of information of this kind could create problems before or after a contract is made. With the help of modern telecommunication, the Internet, and the multi-media, situations similar to Laidlaw are less likely to occur again because information can be transmitted around the world much more quickly and at a lower cost than in 1812. However, even a few minutes difference might be enough to earn a fortune for a trader.<sup>7</sup> Information dissemination is still an issue that has to be considered, especially when we consider the fact that not every trader possesses equal tools and expertise in the risk trading market.

*Laidlaw* is a typical example of a pre-contractual disclosure issue. If non-disclosure pertains after the conclusion of a contract, it might become a so-called “moral hazard” problem. In this paper, we will focus on information issues in a pre-contractual context. Against this backdrop, we might find that information creates problems in various ways. For example, the following situations might happen:

- (1) one party provides false information to the other party with regard to a fact;
- (2) one party makes his prediction and this prediction turns out to be inaccurate;
- (3) one party conceals some information from the other party when the

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5. We should be aware that some commentators distinguish “risk” further from “uncertainty” on the ground that the probability of a risk is known (though whether it will actually occur remains unknown), while the probability of an uncertainty remains unknown. See Desmond Eppel, *Risky Business: Responding to OTC Derivative Crises*, 40 COLUM. J. TRANSNAT’L L. 677, 687 (2000); see also Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 743 (1999).

6. Another interesting story is how a banker called Nathan Rothschild earned huge profits by having advance information about the outcome of the Battle of Waterloo before other traders learnt the news. Rich Karlgaard, *Winning — It’s All About Information*, FORBES, available at [http://www.forbes.com/2005/10/20/karlgaard-rich-information\\_comm05\\_cz\\_rk\\_1024karlgaard.html](http://www.forbes.com/2005/10/20/karlgaard-rich-information_comm05_cz_rk_1024karlgaard.html) (last visited Oct. 24, 2005). See also EMILIOS AVGOULEAS, *THE MECHANICS AND REGULATION OF MARKET ABUSE* 122 (2005).

7. Dan Morgan has depicted how a trader picked up the most up-to-date news from all around the world, including listening to the English version of Radio Moscow in the hope of getting a tip about Russian grain, and how a trader recovered a loss by delaying publishing news regarding a new big transaction. DAN MORGAN, *MERCHANTS OF GRAIN* 282-86 (1980).

other makes an inquiry;

- (4) a person is not asked for key information by the other party, and chooses not to disclose (or hides) it;
- (5) one party is either the generator of a price-influencing event or a close insider to that event. In this paper, we will focus on what Professor Treitel has called “‘pure’ non-disclosure.”<sup>8</sup> In principle, then, we will deal with issues (3) to (5) rather than going into detail over cases of deceit or misrepresentation except where relevant.

It should be noted that the importance of information is not exclusive to risk trading contracts but is relevant to all kinds of transactions. Information is crucial in ascertaining the real value of a property (e.g. the health of pigs on sale<sup>9</sup> or the unknown quality of a stone<sup>10</sup>). Information is also important for service or employment contracts (e.g. a criminal record in the case of a security guard). There is no doubt that the law regarding fraud, misrepresentation and mistake plays a role in shaping the relationship between parties. We recognise that information is essential for risk trading, but this does not necessarily mean that risk trading requires a different disclosure rule from other commercial contracts. Thus, in this paper, we will first discuss the current common law rules with regard to pre-contractual information disclosure and the limits of the laws regarding deceit and misrepresentation, and we will further examine some special categories where there is a duty of disclosure that may be applied to risk trading contracts.

#### B. *Current Laws on Pre-contractual Disclosure*

If one party’s lack of information causes some problems, forcing the other party to disclose the information (by avoiding the contract, providing compensation or using other remedies) seems to be the most direct way to address the issue. However, in general, there is no pre-contractual duty of disclosure in common law.<sup>11</sup> “Let the buyer beware” (*caveat emptor*) is thus the general principle.

On the other hand, there also exist several exceptions to the general non-disclosure rule. The first exception is the so-called contract of utmost good faith (contract *uberrimae fidei*), of which insurance is the most typical

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8. Professor Treitel uses the term “pure non-disclosure” to describe the situation where non-disclosure does not give rise to misrepresentation, negligence, or deceit. GUENTER TREITEL, *THE LAW OF CONTRACT* 436 (2007).

9. *Ward v. Hobbs*, (1877) 3 Q.B.D. 150 (C.A.).

10. *Wood v. Boynton*, 25 N.W. 42 (Wis. 1885).

11. In *Keates v. Cadogan*, it was held that the landlord did not have to disclose the condition of the flat to potential tenants. *Keates v. Cadogan*, (1851) 10 C.B. 591. See also *Bell v. Lever Brother, Ltd.*, [1932] AC 161 (H.L.) (*per* Lord Atkin); *Laidlaw v. Organ*, 15 U.S. 178 (1817).

example.<sup>12</sup> To observe the utmost good faith “the assured must disclose to the insurer, before the contract is concluded, every material circumstance which is known to the assured.”<sup>13</sup> If the assured fails to disclose, the insurer could avoid the contract.<sup>14</sup>

Secondly, a person might have to disclose information if he has a special relationship with the counterparty. Where there is a relationship of trust between parties, there may be a duty of disclosure; for example, pre-contractual disclosure might be required to a certain degree for a partnership agreement<sup>15</sup> or a contract to marry or separate.<sup>16</sup> A stronger form of trust and confidence would create what we call a fiduciary relationship. However, we should be aware that a fiduciary duty does not automatically imply a duty of disclosure. We have to carefully analyse the extent of fiduciary duty in different contexts before concluding whether a party has to disclose certain information before a contract is made.

Thirdly, disclosure is frequently required by statute. For example, a company wishing to list its shares on a stock exchange has to disclose certain information to investors in the listing particulars or prospectus.<sup>17</sup> We should be aware that while the Financial Services Authority (FSA) imposes a duty on issuers of financial instruments traded on regulated markets (i.e. exchanges) to disclose inside information,<sup>18</sup> this duty of disclosure is not extended to all traders on the financial market (notably OTC derivative traders). We will have further discussion of insider dealing later.

Fourthly, the need to disclose information may derive from tort law. A person might have to disclose to avoid fraud or misrepresentation, particularly when there is a continuous representation.<sup>19</sup> It is not surprising that several non-disclosure cases refer to “fraud.”<sup>20</sup> Arguably, a person might have to disclose certain information to avoid liability under the tort of negligence if a duty of care is established. However, we should note that

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12. Marine Insurance Act, 1906, 6 Edw 7, c. 41, § 17 (Eng.).

13. *Id.* § 18.

14. *Id.*

15. See *Conlon v. Simms*, [2006] 2 All E.R. 1024 (Ch.).

16. LAW RELATING TO ACTIONABLE NON-DISCLOSURE §§ 1.05, 10.01 & 11.01 (George Spencer Bower, Richard John Sutton & Alexander Kingcome Turner eds., 1990).

17. See Financial Services and Markets Act, 2000, c. 8, § 80 (hereinafter *FSMA 2000*).

18. See FSA Handbook, DTR 2. For its text, *availavle at* <http://fsahandbook.info/FSA/html/handbook/DTR> (last visited Feb. 4, 2009).

19. The definition of “fraud” or deceit could be found in *Derry v. Peek*, (1889) 14 App. Cas. 337, 374 (H.L.) (*per* Lord Herschell). For continuous misrepresentation, see *With v. O’Flanagan*, [1936] Ch. 575 (C.A.); *Spice Girls Ltd. v. Aprilia World Services BV*, [2002] EWCA Civ. 15. See also RESTATEMENT (SECOND) OF CONTRACTS § 161 (1979). *Cf.* Unfair Commercial Practices Directive, 2005/29/EC, Articles 6 & 7. For its text, *availavle at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:149:0022:0039:EN:PDF> (last visited Feb. 5, 2009).

20. For example, Lord Mansfield’s remarks on insurance disclosure, see *infra* notes 63 & 64; and Mr. Justice Blackburn’s analysis on insider dealing, see *infra* note 132.

liability in tort law does not necessarily mean a duty to disclose to the counterparty. In addition, a person must avoid misrepresentation, but this would not be translated into a duty to disclose unless the non-disclosure itself is deemed a misrepresentation.

In principle, one is not liable for one's silence unless such silence might establish fraud or misrepresentation.<sup>21</sup> Thus, one might escape liability if one merely chooses not to disclose information to the other party rather than disclosing wrong information, which increases the difficulty of using the concepts of deceit or misrepresentation to deal with the situation in *Laidlaw*. Things could become more complicated if the other party inquires about knowledge on a certain matter and the first party does not answer properly. We should note that other aspects of private law have evolved to address some of the issues regarding silence. For example, product liability and product safety regulations also force a manufacturer to disclose certain information to consumers.<sup>22</sup>

It is important to note that there is a limited class of duty of disclosure in New York. Under New York law:

In business negotiations, an affirmative duty to disclose material information may arise from the need to complete or clarify one party's partial or ambiguous statement ... or from a fiduciary or confidential relationship between the parties... Such a duty may also arise ... where: (1) one party has superior knowledge of certain information; (2) that information is not readily available to the other party; and (3) the first party knows that the second party is acting on the basis of mistaken knowledge.<sup>23</sup>

This duty of disclosure has often arisen in the context of fraud and misrepresentation.<sup>24</sup>

In short, what could be perceived as "fraud" by the general public might not translate directly into the tort of deceit or misrepresentation. The tort of deceit and the law of misrepresentation could well apply where one makes a

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21. Blackburn J states that "a mere abstinence from disabusing the purchaser of that [mistaken] impression is not fraud or deceit." *Smith v. Hughes*, (1871) 6 Q.B. 597, 607 (H.L.). See also *Ward v. Hobbs*, (1877) 3 Q.B.D. 150 (C.A.); *With v. O'Flanagan*, [1936] Ch. 575 (C.A.); *HIH Casualty and General Insurance Ltd. v. Chase Manhattan Bank*, [2001] 2 LLOYD'S REP. 483, 494 (C.A.) (*per Rix LJ*).

22. Consumer Protection Act, 1987, c. 43, §§ 2 & 11 (Eng.).

23. *Banque Arabe et Internationale d'Investissement v. Maryland National Bank*, 57 F.3d 146, 155 (2d Cir. 1995). See also *Young v. Keith*, 492 N.Y.S.2d 489 (N.Y. App. Div. 1985). We should also notice that some American courts did impose a duty to disclose defects of a house if the seller knows of a defect that would materially affect the value of the house. See *Johnson v. Davis*, 449 So. 2d 344 (Fla. Dist. Ct. App. 1985); *Soloman v. Birger*, 477 N.E.2d 137 (Mass. App. Ct. 1985).

24. In both *Banque Arabe, id.*, and *Young, id.*, this duty was discussed in the context of fraud.



wrong statement with regard to a fact; likewise, spreading false information in the financial market is usually prohibited.<sup>25</sup> However, their application is limited where a statement is merely an opinion and might not be “false” in the strict sense. The broader meaning of “fraud” might be more of rhetorical than of any real use. We have to recognise the limited scope of the common law remedies for deceit and misrepresentation with respect to information problems, particularly when they involve pure non-disclosure of certain information.

### C. *Theories of Disclosure or Non-Disclosure*

It is difficult to provide a comprehensive theory that incorporates all the disclosure and non-disclosure positions in law. Where there is no previous contractual relationship between the same two parties, a duty of disclosure cannot be based on the contract itself. As Judge Posner observed, “[a] general duty of disclosure would turn every bargaining relationship into a fiduciary one,”<sup>26</sup> which is not desirable as a matter of law. On the other hand, the laws of tort, deceit, and misrepresentation operate as a restraint on the common law non-disclosure rule. When a non-disclosure is seen as a wrong in the eyes of law, it has to be corrected. But it is the area between fraud/misrepresentation and the common law non-disclosure rule that invites problems.

We have noted at least two levels of discussion regarding disclosure of information. On the one hand, there are debates on pre-contractual disclosure issues for each individual contract, particularly in the context of sales and insurance, where the discussion focuses on the private law impact of non-disclosure. On the other hand, there are many arguments on the rights and wrongs of mandatory disclosure rules in the securities market. Interestingly, these discussions show some similarities. Using a kind of shorthand, we might call concerns about a single transaction the “micro level” and those about the market the “macro level.”

First, fairness is a key concern at both micro and macro levels. To some eyes non-disclosure is simply not “fair,” though why it is not fair might require further explanation. For example, if a private seller knows very well that his house is infested with termites but chooses not to say so clearly, it is fair to say that most buyers would feel they have been treated unfairly, if not fraudulently, by the seller’s concealment in this circumstance.<sup>27</sup> The duty of

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25. For example, see *CFTC v. Atha*, 420 F.Supp.2d 1373 (N.D.Ga. 2006); *CFTC v. Erskine*, 2006 U.S. Dist. LEXIS 26319 (N.D. Oh. 2006); *CFTC v. Foley*, 2006 U.S. Dist. LEXIS 70437 (S.D. Oh. 2006).

26. *Federal Deposit Insurance Corp. v. WR Grace & Co.*, 877 F.2d 614, 619 (7th Cir. 1989).

27. See for example, *Hill v. Jones*, 725 P.2d 1115 (Ariz. Ct. App. 1986); *Obde v. Schlemeyer*, 353

utmost good faith in insurance law might also embrace the idea of unfairness and similar lines of thinking could also be found in the context of insider dealing.

However, whether a conduct should be considered “unfair” to the point of affecting a concluded transaction is certainly subject to disagreement, so this is where we should be cautious about making a fairness argument, as the standard for unfairness is open to challenge.<sup>28</sup> Inequality of bargaining power might also influence how we perceive “fairness” in a certain case; the same act (of non-disclosure) might be deemed acceptable practice between two business entities, but our conclusion might be different if it concerns a transaction between a business and a customer. In short, we do recognise that some disclosure rules might have moral underpinnings, but it is not easy to form a complete ethical theory as guidance for each issue of disclosure.

Secondly, economists provide certain arguments for the view that a person should not be forced to disclose information which has higher productive value, so as to encourage people to invest in discovering this information. In contrast, withholding information that would produce no further social value (e.g. a person withholding information acquired by eavesdropping on other people’s conversations) may only induce more opportunistic behaviour.<sup>29</sup> A few academic debates use similar but subtly different language on this issue.<sup>30</sup> In an article, Eisenberg argued that a seller should disclose in any event but a buyer may be free from this duty if the information is more than foreknowledge,<sup>31</sup> if it is not acquired through improper means, or if there is a relationship of trust and confidence between

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P.2d 672 (Wash. 1960).

28. See generally Alan Strudler, *Moral Complexity in the Law of Nondisclosure*, 45 UCLA L. REV. 337 (1997) (arguing that because of the complexity and conflict inherent in this area of law, deontological ethical theory provides a better normative explanation of nondisclosure law than do the prevailing theories, including both economic analysis and social contract theory).

29. See generally Melvin A. Eisenberg, *Disclosure in Contract Law*, 91 CALIF. L. REV. 1645 (2003) (examining the applicability of the Disclosure Principle to a series of variables, such as whether the relevant information was produced adventitiously or by a deliberate investment, whether the information was properly acquired, whether the information is productive information or mere foreknowledge, whether the knowing party is a buyer or a seller, and whether the parties were in a relationship of trust and confidence).

30. For example, Kronman distinguishes information acquired casually and information obtained intentionally and requires the former to be disclosed but not the latter. See Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 13 (1978). Cooter and Ulen distinguish productive information (that could be used to produce wealth) and redistributive information (which only redistributes wealth) and requires the holder of the latter type to disclose. ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 273 (3d ed. 2000). See also Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971).

31. The concept of “foreknowledge” was first introduced by Hirshleifer in 1971 in contrast to the concept of “discovery.” Foreknowledge means knowledge that will be evident to all in due time, which means something that will be autonomously revealed. In contrast, discovery is to recognise something that possibly already exists, though it is hidden from view. See *id.*

parties.<sup>32</sup> We do not intend to enter into these debates in this paper. Nevertheless, we should be aware that holding material information in the pre-contractual stage would have certain economic effect on contractual parties and society.<sup>33</sup>

Thirdly, as there are some concerns with the integrity of “prices” or the market, economic analysis has a stronger appeal at the macro level, particularly in the securities market.<sup>34</sup> Presumably, in an efficient market, the current market price should reflect all the information available in the market. Several finance theories explore the relationship between market information and the market prices of securities (so-called “market efficiency”).<sup>35</sup> No matter how quickly information percolates into the market, it is beyond doubt that information does in fact influence the market and in turn investors. Thus, if a piece of material information is not disclosed to the market in time, this might mean traders buy or sell at the “wrong” price, in the sense that the price does not reflect the true market value. Thus, economic theories lay the foundation for the modern securities mandatory disclosure rule. However, we should be aware that there are other theories arguing against the mandatory disclosure regime in securities law.<sup>36</sup>

Economic and moral arguments may not be mutually exclusive. While it seems natural to focus on the price issues on the securities market, we should also note that information might also influence market prices outside organised securities exchanges (e.g. in *Laidlaw*). It is not clear how far the wrongful price theory can be applied to non-securities markets or non-standardised markets. To some extent, it requires further empirical research to justify market efficiency and to build a link between a piece of information and prices in specific spot or futures markets. In contrast, where economic arguments seem to be dominant in the securities market, there is still a certain line of moral arguments that attempt to justify the use of some mandatory disclosure rules in the securities market, particularly regarding insider dealing. With regard to risk trading contracts, it is important to be aware of different concerns rather than relying on a single school of thought.

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32. See generally Eisenberg, *supra* note 29, at 1687.

33. CHARLES FRIED, *CONTRACT AS PROMISE* 77-85 (1981); see also Deborah A. DeMott, *Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions*, 19 DEL. J. CORP. L. 65 (1994).

34. The wrongful price theory might concur with “artificial price” arguments in defining market manipulation. Theories relating to non-disclosure and market manipulation might be connected in cases regarding insider dealing, which we will discuss in *infra* part 5.

35. For discussion on the so-called efficient capital market hypothesis, see AVGOULEAS, *supra* note 6, at 44.

36. See AVGOULEAS, *supra* note 6, at 179-83.

#### D. *Summary*

In this part, we determined that information is important to hedging and speculation as the evaluation of future risks depends heavily on information and expertise; thus, this opens the door for people to gain profit from their information advantage. The general rule in common law is that one does not have to disclose information before a contract is made, except in certain exceptional situations. In addition, we also find that the laws of deceit and misrepresentation have a limited application to the silence of a trader in a pre-contractual context. Since information problems appear in every kind of contract, there is no reason to create a different rule in the legal structure merely because evaluation of risks requires a lot of information. The approach taken in this paper is to fit risk trading contracts into the general common law structure. The laws of deceit and misrepresentation could apply if all elements are satisfied. What we are concerned with is whether one party has to disclose information to another party before concluding a contract in the context of risk trading. In the following sections, we will try to fit risk trading contracts into certain exceptions to the general non-disclosure rule and decide whether derivative instruments naturally come under these exceptions.

### III. MANDATORY DISCLOSURE IN THE SECURITIES MARKET: COMPARISON WITH FUTURES EXCHANGE AND SECURITISED PRODUCTS

Before turning to the private law side of disclosure discussion, it would benefit this discussion first to look at the mandatory disclosure rules in the securities market. It is natural to draw a comparison between the futures market and the securities market, since futures contracts are also traded in organised exchanges, like many listed securities. While it is instructive to note the role of the securities disclosure rule and the insider dealing rule in maintaining the market, we should not ignore the differences between securities and futures contracts that might lead to various legal implications.

Two aspects of securities disclosure impinge upon the issuer of a stock or a bond. On the one hand, the issuer of a security must provide some information in the prospectus when first issuing or listing the securities in the market for investors to subscribe.<sup>37</sup> This is disclosure in the so-called “primary market.” On the other hand, the issuer is subject to a continuous duty of disclosure after the initial public offering, periodically having to disclose the operation of business and relevant accounting documents.

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37. For UK law, *see* FSMA 2000 §§ 80-82; for US law, *see* Securities Act of 1933 § 10, 15 U.S.C. 77j (2000).

Depending on statutory wording, key information that may have an impact on the market prices of the securities should also be disclosed promptly to the public.<sup>38</sup> This is disclosure in the “secondary market.” In addition, the insider dealing rule also supplements the general securities disclosure rule such that an “insider” may not exploit information for his own benefit before the information is published through the proper channels. The exact scope of securities disclosure rules depends on statutory wording and thus varies from jurisdiction to jurisdiction. The same may also be said for the insider dealing rule.

Different legal consequences ensue from non-disclosure under securities laws, where non-disclosure does not render a contract void (as in insurance), but regulators may impose penalties for failure to disclose properly.<sup>39</sup> The issuer or directors of the issuing company might also be liable for damage suffered by subscribers.<sup>40</sup> Where the disclosed information is false or misleading, there might be an overlap with the laws of deceit and misrepresentation.

In addition, what is special in the securities disclosure rule is that it refers to general “issuance.” In the primary market, disclosure in the prospectus or listing particulars is prior to each individual subscription, but non-disclosure does not necessarily give the subscriber the right to set aside his subscription. In the secondary market, the issuer should disclose information to the market regularly or when necessary. Unlike in insurance, the securities disclosure rule does not refer to any specific transaction in the secondary market. A stockholder might sell his shares to another buyer without disclosing anything, unless he is under a duty to disclose or if he is prohibited from using his informational advantage. The insider dealing rule refers to individual transactions in the market made by “insiders.” As with securities mandatory disclosure, the insider dealing rule does not avoid a contract, but imposes penalties or orders disgorgement of profits as remedies.<sup>41</sup>

The mandatory securities disclosure rule exists partly because of the nature of securities (a stock, a bond or other investment contracts as defined by statutes), whose price depends on the value and performance of the issuing company. The value of a share in a company is determined by many

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38. See generally FSA Handbook, Disclosure Rules and Transparency Rules (hereinafter DTR); for US law, see SEC Regulations S-B, S-K and S-X, 17 C.F.R. parts 228, 229 and 210 (2008).

39. FSMA 2000 § 91.

40. FSMA 2000 § 90. See also *Re South of England Natural Gas and Petroleum Co. Ltd.*, [1911] 1 Ch. 573 (Ch.). Per Swinfen Eady J, “[i]n my opinion the allottee is not entitled to rescind his contract because of any breach of the statutory requirements, which extend to such comparatively unimportant matters as the names and addresses of the company’s auditors. His remedy is against the directors and other persons responsible for the prospectus.” At 577.

41. FSMA 2000 § 382.

factors, including the operation of the company, its sales figures, the financial management of its account, and the prospects of the issuing company. The price of a corporate bond is influenced by the creditworthiness of the issuing company which is also affected by the issuer's performance in its own business. The value of a unit trust is basically decided by the portfolio value of the investment instruments held by the trust. Given that any positive or negative information could influence the market price — the value for holders of the securities — it is argued that the issuer should promptly provide correct information to the market.<sup>42</sup> Thus, requiring the issuer to disclose information to the market is a way both to maintain the market and to ensure the efficiency of the market price.

In contrast, this concern is less important in a futures exchange. On the one hand, a futures price represents the market's expectation of the future (or, to some extent, traders' expectations). A futures market is not, like the securities market, a spot market, so it is relevant to ask how far a futures price might be comparable to its corresponding spot price. The gold price for a December 2006 delivery contract in April 2006 is the market's expectation of the value of gold in December 2006 at the time of April 2006 and of course this is different from spot market gold sales prices in April 2006, which represent the current market value of the same amount of gold if one wants to take immediate delivery.<sup>43</sup> Moreover, a "true" futures price might not be easy to establish in any event.<sup>44</sup> Why would we need the futures market if we could already establish future price with a good degree of accuracy? So we can only wait for the future to prove whether or not the futures price at a certain point of time in the past was correct. Thus, we have to be careful when applying the analysis developed in the spot securities market to the futures market.

On the other hand, it is also probably not practical to impose a general duty of disclosure on every futures trader. A general mandatory disclosure system in the commodities market would mean that, if a farmer traded in the futures market, he would have to disclose information whenever he produced the crops for sale (*cf.* the primary securities market) or make periodical statements about the conditions of his crops whenever a specific futures

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42. See AVGOULEAS, *supra* note 6, at 45-56.

43. For the relationship between spot prices and corresponding futures prices, see particularly Mustill J's remark in *Gebrüder Metelmann GmbH & Co KG v. NBR (London) Ltd.*, [1984] 1 LLOYD'S REP. 614, 623-24 (C.A.).

44. The "artificial price" argument might have important implication in establishing market manipulation. However, this "artificial price" approach has also been heavily criticised as it is difficult to prove an "artificial" price. Daniel R. Fishel & David J. Ross, *Should the Law Prohibit 'Manipulation' in Financial Markets?*, 105 HARV. L. REV. 503 (1991) (attempting to provide what existing literature lacks — a principled analysis of concept of manipulation); see also Wendy Collins Perdue, *Manipulation of Futures Markets: Redefining the Offense*, 56 FORDHAM L. REV. 345 (1987) (offering a fresh approach to defining manipulation).

contract remained open for trading (*cf.* secondary securities market). It is not impossible to establish this kind of regime, but it would be costly to maintain such a system. We should be aware that the basis of the securities disclosure rule is built on the basis that an issuer has to apply for authorisation from, or register with, the financial regulator before issuing or listing securities. The same does not usually apply in the commodity futures market.

We could also examine the issue from another angle. As a US judge has argued, the securities market was established for the formation of capital and the futures market for hedging.<sup>45</sup> It is normal that a lender attempts to acquire certain information about the borrower in order to ensure the return on his investment or to secure future repayment and yet no duty of disclosure is imposed in the case of loan agreements. Raising funds by way of issuing securities to the general public raises further concerns about investor protection because the general public might not be able to obtain useful information when making investments (compared with specialised lending banks giving loans or mortgages).<sup>46</sup> In contrast, futures contracts have no such pedigree to justify a pre-issuance and continuous disclosure rule.

If we follow this line of analysis, there might be good reason to apply the securities disclosure rule to those securitised hedging instruments as they may be seen as “securities.” For example, a catastrophe bond is still a bond, although the repayment of the bond is conditional upon the non-occurrence of the catastrophic events defined in the indenture.<sup>47</sup> Securitised instruments are not issued like a straight corporate bond as they are usually structured through a special purpose vehicle (SPV).<sup>48</sup> Nevertheless, similar concerns might arise with respect to these hybrid instruments and, thus, one might argue that hybrid instruments should be regulated as securities. Whether they should be treated as traditional securities (e.g. corporate shares) or be regulated by special rules is another matter.<sup>49</sup>

In sum, the risk trading market is not directly comparable to the

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45. *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537, 543 (7th Cir. 1989) (*per* Judge Easterbrook).

46. In contrast, the US securities law exempts an issuer from the obligation to register his transaction if it does not involve any public offering. Security Act of 1933 § 4, 15 U.S.C. 77d (2000).

47. Under a CAD bond, the bond issuer receives money from investors. If the catastrophic event does not occur, the catastrophe bond is similar to a normal bond, with periodic interest payments and a final principal repayment. However, if the event does occur, the bond issuer can deduct an amount from the principal that is returned to the bondholder. Thus, risks from a catastrophic event can be transferred from an insurer (as bond issuer) to the investors. SATYAJIT DAS, *STRUCTURED PRODUCTS VOLUME 2: EQUITY; COMMODITY; CREDIT & NEW MARKETS* 1212 (3d ed. rev. ed. 2006).

48. SCHUYLER K. HENDERSON, *HENDERSON ON DERIVATIVES* Chapter 8 (2003); *id.* at chapter 12; *see also* Xin Zhang, *Trends and Developments in Cross-Border Securitisation, Part 1: Legal Structures and Analysis*, 15 J. INT'L BANKING & FIN. L. 269 (2000); Geoff Fuller & Franz Ranero, *Collateralised Debt Obligations*, 20 J. INT'L BANKING & FIN. L. 343 (2005).

49. Tony Ciro, *Game Theory in Financial Markets Litigation*, 20 J. INT'L BANKING L. REG. 315 (2005).

securities market. Although securities can be traded on or off exchanges like futures or many commodities, in the securities market the mandatory disclosure rule lies in the nature of securities and cannot be transposed seamlessly onto exchange-traded futures contracts.

#### IV. VOIDABLE CONTRACTS: RISK TRADING AND UTMOST GOOD FAITH

##### A. Background

Insurance and guarantee contracts provide a good comparison with risk trading contracts. Insurance contracts are clearly intended to cover loss from future risks. Guarantees, on the other hand, serve the purpose of ensuring the performance of a debtor's obligation.<sup>50</sup> Interestingly, both types of contract are subject to a duty of disclosure but on different legal grounds. An insurance contract has long been labelled a contract *uberrimae fidei*.<sup>51</sup> An assured has to disclose material information to the insurer to observe the duty of utmost good faith; otherwise the contract could be avoided.<sup>52</sup>

On the other hand, there is also a duty of disclosure for contracts of guarantee or suretyship. It was stated that:

[A] duty was imposed by the law upon creditors to disclose, when negotiating for a suretyship contract, all material facts — i.e., all facts which if disclosed would tend to incline a prudent proposed surety to decline to enter into such a contract, or would tend to persuade him to ask for a greater reward for it than had previously been proposed.<sup>53</sup>

However, a contract of guarantee is not considered a contract *uberrimae fidei*.<sup>54</sup>

It is necessary to explore what is meant by “utmost good faith” and why an insurance contract should require utmost good faith. Insurance as contracts *uberrimae fidei* can be traced back to the case of *Carter v. Boehm*<sup>55</sup>

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50. *Moschi v. Lep Air Services Ltd.*, [1973] A.C. 331 (H.L.) (*per* Lord Diplock). We should be aware that a guarantee contract might also be regarded as insurance if it satisfies the requirements for an insurance contract. *See Seaton v. Heath*, [1899] 1 Q.B. 782, 792-793 (C.A.) (*per* Romer J).

51. *Carter v. Boehm*, (1766) 3 Burr 1905; *Whittingham v. Thornburgh*, (1690) 2 Vern 206; 23 ER 734; Marine Insurance Act, 1906, 6 Edw 7, c. 41, § 17 (Eng.). *See also Pan Atlantic Insurance Co. Ltd. v. Pine Top Insurance Co. Ltd.*, [1995] 1 A.C. 501 (H.L.); *Manifest Shipping Co. Ltd. v. Uni-Polaris Insurance Co. Ltd. (The Star Sea)*, [2003] 1 A.C. 469 (H.L.).

52. Marine Insurance Act, 1906, 6 Edw 7, c. 41, § 18 (Eng.).

53. *Hamilton v. Watson*, (1845) 12 C & F 109, 118.

54. *Royal Bank of Scotland v. Etridge (No 2)*, [2002] 2 A.C. 773, 848 (H.L.) (*per* Lord Scott of Foscote).

55. *Carter v. Boehm*, (1766) 3 Burr 1905.



in the 18<sup>th</sup> century, where Lord Mansfield stated that “[g]ood faith forbids either party, by concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing the contrary.”<sup>56</sup> While Lord Mansfield’s attempt to establish a general requirement of good faith in the contract law failed, it nevertheless survived in insurance law.<sup>57</sup> An interesting point to note is that Lord Mansfield only used the term “good faith,” but the Marine Insurance Act 1906 regards insurance as a contract of “utmost good faith.”<sup>58</sup>

Since good faith is already a rather ambiguous concept, it is not clear what utmost good faith means. It has been suggested that “[t]he connotation appears to be the most extensive, rather than the greatest, good faith.”<sup>59</sup> Frequently, it is easier to identify conduct that is not in utmost good faith (or, more straightforwardly, is a case of “bad faith”) than to illustrate the concept with a positive description. The most distinguishing feature of utmost good faith is the duty to disclose material information.<sup>60</sup> However, we should note that the duty of utmost good faith is more than just disclosure. Since it applies to both insurers and assureds, and it might thus also be used as a weapon against the insurer.<sup>61</sup> It has been held that an insurer’s right to avoid a contract following non-disclosure by the assured is restricted by the duty of utmost good faith.<sup>62</sup> Thus, the duty of utmost good faith restrains the conduct of both the assured and the insurer. We should take care in drawing the line between the duty of disclosure and a more general duty of utmost good faith.

#### B. *Foundation of Utmost Good Faith in Insurance Law*

The inequality of knowledge is behind the doctrine of utmost good faith in insurance law.<sup>63</sup> For example, a car insurer does not normally know a car

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56. *Id.* at 1910. The same principle was applied to life assurance in 17<sup>th</sup> century in *Whittingham v. Thornburgh*, (1690) 2 Vern 206; 23 ER 734 (cited in PETER MACDONALD EGGERS, *GOOD FAITH AND INSURANCE CONTRACTS* 5 fn 41 (2004)).

57. *Manifest Shipping Co. Ltd. v. Uni-Polaris Insurance Co. Ltd. (The Star Sea)*, [2003] 1 A.C. 469, 492 (H.L.) (*per* Lord Hobhouse).

58. Marine Insurance Act, 1906, 6 Edw 7, c. 41, § 17 (Eng.). For historical development of the concept of good faith and utmost good faith, see R.A. Hasson, *The Doctrine of Uberrima Fides in Insurance Law: A Critical Evaluation*, 32 M.L.R. 615 (1979).

59. *The Star Sea*, *supra* note 57, at 492 (*per* Lord Hobhouse).

60. Marine Insurance Act, 1906, 6 Edw 7, c. 41, §§ 18 & 20.

61. John Lowry & Philip Rawlings, *Insurers, Claims and the Boundaries of Good Faith*, 68 M.L.R. 82 (2005); H. Y. Yeo, *Post-Contractual Good Faith — Change in Judicial Attitude*, 66 M.L.R. 425 (2003).

62. *Drake Insurance plc v. Provident Insurance plc*, [2004] Q.B. 601 (C.A.).

63. *Per* Lord Mansfield, “[t]he special facts upon which the contingent chance is to be computed lie most commonly in the knowledge of the insured only. The underwriter trusts to his representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge to mislead the underwriter into a belief that the circumstance does not exist, and to induce him to

owner's complete driving record; nor could a health insurer normally know if the assured has any hidden or untold disease. Such an asymmetric spread of information could lead an insurer to underwrite a risk at too low a premium. Therefore, the insurer needs to acquire the relevant information from the assured in order to evaluate the proper level of risk exposure and determine the correct premium. However, given the direct connection between information and the level of premium he will pay, the assured has some incentive not to disclose material information to the insurer, leaving the insurer in a disadvantageous position.

A common response is to argue that non-disclosure constitutes fraud.<sup>64</sup> However, as we saw earlier, mere silence does not automatically trigger misrepresentation, mistake, or the tort of deceit, and it is not always clear what sort of information need or need not be disclosed to the insurer. Where the insurer makes no specific inquiry, there is no specific reason why an assured should be liable for fraud or misrepresentation. The assured might not intend to defraud the insurer, so his silence is not necessarily a misrepresentation. The situation would be trickier if the insurer makes an inquiry but the assured decides to keep silent; nevertheless, such silence is not unconditionally fraud. Undoubtedly, an assured could still be liable for concealment of information if his actions satisfy the criteria for deceit and misrepresentation. However, the problem under consideration here is the circumstance where a concealment or non-disclosure does not constitute intentional deceit or misrepresentation but still raises questions of bad faith or unfairness. The creation of the concept of "utmost good faith" could fill the gap between restrictive fraudulent laws and the common law non-disclosure rule.

Economic analysis could provide further support for some kind of disclosure requirement on the part of the assured. When insurers issue policies they calculate the premiums to reflect the true level of risk exposure, but insurance companies also try to spread the risk among other assureds falling into the same category. Premiums are calculated not only on the basis of the specific risk exposure of the assured but also on the general occurrence rate of this same risk in the market (e.g. the incidence of breast cancer among British women). Thus, the expected loss from non-disclosure by one assured could be transferred to other assureds by their being charged higher premiums than would apply in a general climate of full disclosure. In

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estimate the risk as if it did not exist. ... Although the suppression should happen through mistake without any fraudulent intention, ... the policy is void, because the risk run is really different from the risk understood and intended to be run at the time of the agreement." *Carter v. Boehm*, (1766) 3 Burr 1905, 1909-1911.

64. Indeed, Lord Mansfield made a strong statement that "[k]eeping back such circumstance is a fraud." *Id.*

addition, full disclosure of material information by assureds might help to address the moral hazard issue created by asymmetric information.<sup>65</sup> “Adverse selection”<sup>66</sup> may occur when an insurer selects those with a good disclosure record or those relatively safe from risks as the target group for insurance rather than underwriting risks from the wider public. This may result in high-risk groups (usually those who need more protection from insurance) being excluded from enjoying the benefits of insurance. However, while economic analysis may provide some explanation of the *raison d’être* of the insurance disclosure rule, it does not explain why “utmost good faith” is required.

The same grounds could also be used to explain why a contract of guarantee is not a contract *uberrimae fidei*. The scope of the guarantee disclosure is rather limited. In Lord Campbell’s words, the criterion is:

Whether there is anything that might not naturally be expected to take place between the parties who are concerned in the transaction, that is, whether there be a contract between the debtor and the creditor, to the effect that his position shall be different from that which the surety might naturally expect; and, if so, the surety is to see whether that is disclosed to him.<sup>67</sup>

Indeed, the information problem that arises with a guarantee is not the same as that in insurance. The creditor (like an assured) does not necessarily have an advantage in acquiring credit information about the guarantor. In addition, since no premium is paid between guarantor and creditor, there is no further economic implication to protect other creditors (like assureds). This also opens the door to examine the debtor-guarantor relationship and issues relating to duress and undue influence in order to explain why guarantors choose to absorb the debtor’s credit risk.<sup>68</sup> If, as Lord Campbell suggests, a creditor should only disclose information that could make the guarantee or suretyship different from what he might naturally expect, misrepresentation or even mistake might be a better explanation.<sup>69</sup>

Moreover, in the modern era, the concept of “utmost good faith” serves other purposes than merely dealing with the inequality of knowledge. One

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65. *Id.* at 50.

66. See COOTER & ULEN, *supra* note 30, at 51.

67. *Hamilton v. Watson*, (1845) 12 Cl & Fin 109, 118-119 (*per* Lord Campbell), quoted in *Levett v. Barclays Bank plc*, [1995] 1 W.L.R. 1260, 1276 (Q.B.).

68. See *Royal Bank of Scotland v. Etridge (No 2)*, [2002] 2 A.C. 773 (H.L.); *Barclays Bank plc v. O’Brien*, [1994] 1 A.C. 180 (H.L.).

69. Vaughan Williams LJ took the view that “a creditor must reveal to the surety every fact which under the circumstances the surety would expect not to exist, for the omission to mention that such a fact does exist is an implied representation that it does not.” *London General Omnibus Company Ltd. v. Holloway*, [1912] 2 K.B. 72, 79 (C.A.).

area stressed by case law is the element of “fair dealing” in a duty of utmost good faith.<sup>70</sup> To some extent, the duty of disclosure could be reconciled with the idea of fair dealing as one might argue that it is unfair for the assured to conceal material information from the insurer.

However, it is easier to show that utmost good faith entails “fair dealing” than the other way round. There is always a certain degree of “fair dealing” in every transaction, yet those commercial transactions are not treated as contracts of utmost good faith. In modern times, when insurance companies are generally more powerful than most assureds, it is also more difficult to base the duty of utmost good faith on the ground of fair dealing and impose a heavier duty of disclosure on the assured, who has less bargaining power.

Lastly, requiring the assured to disclose material information is one thing, but determining the materiality is another. It could be linked to an assured’s duty to disclose or not to conceal information when the insurer makes an inquiry. Given that modern insurers are generally more expert at their business than assureds, an insurer should, in general, have a better idea of what information is required. Thus, there is a trend in insurance law to impose more responsibility on the insurer to make inquiry rather than relying on the assured to disclose information.<sup>71</sup> The development of the duty of disclosure in insurance law is a topic of its own and we need not enter into details here. However, it is important to note that bargaining power and fair dealing arguments can be incorporated into the discussion of the duty of utmost good faith.

Two conclusions may be drawn from the above discussion. First, it is the inequality of knowledge between assured and insurer regarding insured risks that is behind the duty of utmost good faith and the duty of disclosure in insurance law. The duty of utmost good faith could fill in the gap left between fraud laws and the common law non-disclosure rule. Secondly, the duty of good faith has a modern application in addressing the inequality of bargaining power and issues of fair dealing, notably in restricting the advantages of powerful insurers. It is on this ground that we will proceed with our arguments for the use of utmost good faith in risk trading contracts.

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70. *The Star Sea*, *supra* note 57, 491-95 (per Lord Hobhouse); see also *Pan Atlantic Insurance Co. Ltd. v. Pine Top Insurance Co. Ltd.*, [1995] 1 A.C. 501 (H.L.).

71. See generally JULIE-ANNE TARR, DISCLOSURE AND CONCEALMENT IN CONSUMER INSURANCE CONTRACTS (2002); Anthony A. Tarr & Julie-Anne Tarr, *The Insured’s Non-Disclosure in the Formation of Insurance Contracts: A Comparative Perspective*, 50 INT’L. COMP. L.Q. 577 (2001) (arguing that the departure from *caveat emptor* and the allocation of the risk and consequences of non-disclosure to the party will be best placed to provide information pertinent to the transaction is seen as necessary to minimise transaction costs in such dealings).

### C. *Risk Trading and Utmost Good Faith*

#### 1. *Exchange Trading*

Let us start with exchange trading contracts. Exchange-futures contracts are highly standardised such that the exchange contract has become the subject matter of trading instead of the underlying commodity.<sup>72</sup> Since exchange contracts are so standardised, futures trading does not involve a lot of negotiation of terms, except prices and the number of contracts. There is no inquiry and no concealment as traders are not expected to ask or disclose anything other than the desired trading price and the number of contracts on the trading floor or in the computer system. Any disclosure, if required, should be made to the exchange rather than to the counterparty during trading. Thus, it would be meaningless to argue that an exchange contract requires utmost good faith. In contrast, since a trader must have a membership agreement with the exchange and a non-member must have a brokerage or similar agreement with an exchange member,<sup>73</sup> the issue of disclosure in the exchange market could be analysed as a matter of post-contractual disclosure.

It is undeniable that we expect some form of good faith in exchange trading, much as we do in the cases of other commercial contracts. Most traders hope the prices on the market are reliable and reflect the current state of the market or expectations, so they do not want instances of market manipulation or insider dealing. If market manipulation and insider dealing are important concerns, we have to consider whether it is better to address these problems with special rules rather than imposing a general duty of utmost good faith on all futures trading. Given that there are many kinds of futures contracts and traders in the market, a general duty of utmost good faith might in turn make futures transactions fiduciary relationships, a situation that even the securities market has not yet reached.

#### 2. *Over-the-Counter Trading*

In relation to the over-the-counter (OTC) market, the issue of good faith could be examined from several perspectives. The complexity of hedging products and the fast-changing environment of the market makes it difficult

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72. In a way, futures transactions trade “in the contract,” while commercial sales trade “in the commodity.” *CFTC v. Zelender*, 373 F.3d 861, 867 (7th Cir. 2004) (*per Judge Easterbrook*).

73. For example, in the Chicago Board of Trade (CBOT), a non-clearing member must have a clearing agreement with a clearing member, who becomes the “primary clearing member” for that non-member. The existence of a primary clearing member is the pre-condition to trading by non-members. See CBOT Rule 207.01. For its text, available at [http://www.cbots.com/cbot/pub/cont\\_detail/0,3206,931+32175,00.html](http://www.cbots.com/cbot/pub/cont_detail/0,3206,931+32175,00.html) (last visited Feb. 6, 2009).

to reach a single and definitive conclusion on all off-exchange transactions. However, until off-exchange hedging contracts become more consumerised, there is no need to use the concept of “utmost good faith” to address the information problem. Instead, it is more likely that issues of insider dealing or market manipulation will be introduced.

Let us examine the nature of risks and their evaluation in the case of an insurance contract and OTC derivative instruments. In the case of insurance, one may argue that the evaluation of risk exposure is to a certain extent individualised.<sup>74</sup> For example, the determination of the correct premium level for a motor insurance contract depends partly on the driving record of the driver. For health insurance, the insurer needs to know the health condition of the assured in order to calculate how much risk he is exposed to. But this information might not be accessible to the insurer without the assured’s disclosure and, even with some kinds of standardisation in effect, when issuing a policy the insurer still has to know some of the assured’s personal information.<sup>75</sup> Thus, there is a larger margin for the assured to exploit the insurer’s lack of knowledge.

In contrast, the personal element seems to be much diluted in derivative instruments. For market hedging, the risk exposure comes from the fluctuation of the market, which in principle should be external to the control of any risk seller or risk buyer (*cf.* assureds and insurers, respectively). The evaluation of market risk does not depend on the risk seller’s special knowledge as market data is, in theory, open to all traders to discover. Thus, risk sellers do not necessarily have better knowledge than risk buyers.<sup>76</sup> A risk buyer might even have equal or better access to information than a risk seller, so there is no apparent inequality of knowledge in the derivatives market similar to that in the insurance market.

The same could also be argued for standard credit derivatives.<sup>77</sup> In a typical credit default swap (CDS),<sup>78</sup> the risk seller tries to transfer to the risk

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74. Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 *FORDHAM J. CORP. & FIN. L.* 167, 191 (2007).

75. It has also been argued that marine insurance still relies on individualised calculation of risks and negotiation. Thomas J. Schoenbaum, *The Duty of Utmost Good Faith in Marine Insurance Law: A Comparative Analysis of American and English Law*, 29 *J. MAR. L. & COM.* 1, 3-4 and notes 13 & 14 (1998).

76. Save for the situation where the risk seller himself generates information that could influence the market.

77. Credit derivatives can be defined as “a class of financial instrument, the value of which is derived from an underlying market value driven by the credit risk of private or government entities other than the counterparties to the credit derivative transaction itself.” SATYAJIT DAS, *CREDIT DERIVATIVES: CDOs & STRUCTURED CREDIT PRODUCTS* 6 (3d ed. 2005).

78. In a credit default swap (CDS), a party wishing to hedge the credit risk of a “reference obligation” (e.g. a bond) makes a fixed payment periodically or in a lump sum and receives payment from the other party if the “reference entity” (e.g. the bond issuer) defaults, thereby allowing bondholders to hedge the credit risks of the bond issuer. The credit default swap has evolved to cover

buyer the credit risk of the bonds or other credit instruments he holds. Risk buyer and the risk seller probably have equal access to information concerning the credit risk of the third party issuer.<sup>79</sup> So, the basic inequality of knowledge issue does not necessarily arise.

However, the above analysis is based on an assumption that market or credit risks are foreign to both hedgers and speculators, whether they are risk buyers or sellers — if they have equal access to the information, there seems to be no need to ask one party to disclose to the other. Nevertheless, there are some circumstances where this assumption might be false. First, with the advancement of financial engineering, a derivative transaction might be designed so as to incorporate a party's personal traits. For example, there exists the so-called “self-linked” credit derivative, where the risk seller actually sells his own credit risks or those of persons connected to him (e.g. a parent company or a subsidiary).<sup>80</sup> This may resemble insurance in some aspects because risk buyers for such credit derivative instruments might not know as much as the risk seller with regard to the credit risk of the reference entity.

Secondly, where one person conducts a market manipulative scheme to work the market to his favour, to some extent, he has better knowledge of potential market fluctuation than other traders (because he causes it). “Moral hazard” problems might also arise for credit derivative transactions, where the risk buyer “manufactures” a credit event in his favour.<sup>81</sup> It has happened that a lender, purchasing credit default swaps to protect against the credit risk of the loans made to borrowers, intentionally restructured the loans to trigger the payment obligation of a CDS.<sup>82</sup> To date, credit derivatives transactions are conducted mainly between banks and financial or business entities. Thus, concerns about moral hazard might be reduced because the risk buyer is usually capable of spotting potential problems and protecting himself contractually. However, as the design of derivative instruments becomes more personalised, this will create asymmetric information and moral hazard problems similar to those of the insurance field.

Thirdly, where a trader is a corporate insider who has more inside knowledge than other traders, this creates a situation similar to insider dealing in the context of securities laws. Arguably, there could be unequal

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not only the default of a single debt instrument but also the default of one or several debt instruments in a portfolio. *See id.*

79. This is based on an assumption that both the risk buyer and the risk seller are business entities and are generally equal in capacity of making business or financial judgments.

80. Simon Firth, *Self-referenced Credit Derivatives — Are They Enforceable under English Law?*, 1(1) CAP. MARKET. L.J. 21 (2006).

81. Simon Bezzina, *The Protection Seller's Scylla and Charybdis: Negotiating the Moral Hazard Straits in ISDA -based Cash-settled Credit Default Swaps*, 20 J. INT'L BANKING L. REG. 600 (2005).

82. SATYAJIT DAS, *STRUCTURED PRODUCTS VOLUME 2: EQUITY; COMMODITY; CREDIT & NEW MARKETS* 743-44 (3d ed. rev. ed. 2006).

accessibility to information (even for a short period of time). As to the hedging market, potential insider dealing could be solved by extending the insider dealing rule commonly seen in securities regulation. We will address this issue later in this paper.

Fourthly, one day, risk trading products might become more consumerised, which is to say they will be sold to individual consumers rather than to more sophisticated business entities. The resultant inequality of bargaining power might imply an inequality of information about products, the market and the underlying risks. Thus, one could make a further argument to support the imposition of a “good faith” duty upon the stronger side. However, we should be aware that in a typical insurance context it is the assured (usually having less bargaining power) who possesses useful information, rather than the insurer (who usually has greater bargaining power). If the risk trading market becomes more consumerised, it would be the product seller who had better knowledge and expertise rather than individual consumers. This could necessitate further duties on the part of brokers/dealers or financial promoters, or raise so-called suitability issues.<sup>83</sup>

The above discussion shows that it would be inappropriate to reject the idea of the contract *uberrimae fidei* merely on the basis of the argument that the risk evaluation of derivative instruments is not individualised. There are indeed circumstances that in which information is asymmetric and moral hazard problems arise, as in insurance law.

However, imposing a duty of utmost good faith is only one of the possible ways to deal with potential information problems. There may be some instances of “bad faith” trading or concealment that could damage the market and investors. The question we face here is how far the problem could be addressed by a duty of utmost good faith or a duty of disclosure. If breaching a duty of utmost good faith results in a contract being avoided (as in section 17 of the Marine Insurance Act 1906), the significant legal consequences and legal uncertainties involved might not justify the benefits accruing from such a duty. Avoiding contracts requiring only a single performance (like options) is relatively easy to tackle. However, where there are multiple performances (like an interest rate swap), avoiding contracts may create complicated restitution issues, like the series of local authority cases that arose in the UK,<sup>84</sup> especially when the contract has run some time

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83. See for example, *Bankers Trust International plc v. PT Dharmala Sakti Sejahtera*, [1996] CLC 518 (Q.B.); *Peekay Intermark Ltd. v. Australia and New Zealand Banking Group Ltd.*, [2006] 2 LLOYD'S REP. 511 (C.A.); *De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293 (2d Cir. 2002); *K3C Inc. v. Bank of America*, 2006 U.S. App. LEXIS 27437 (5th Cir. 2006); *Power & Telephone Supply Company, Inc. v. Suntrust Banks, Inc.*, 447 F.3d 923 (6th Cir. 2006).

84. See *Hazell v. Hammersmith and Fulham London Borough Council*, [1992] 2 A.C. 1 (H.L.); *Westdeutsche Landesbank Girozentrale v. Islington London Borough Council*, [1996] A.C. 669 (H.L.);



for part of its term. As OTC documentation grows more complicated, breaking the contractual scheme might lead to more problems than solutions.

In addition, several regulatory regimes already exist to deal with these issues. Market manipulation and insider dealing are already punishable by statutes. To some extent, problems may be solved contractually.<sup>85</sup> We should also consider whether courts are better equipped to decide market manipulation and price issues (if we take the good faith approach), rather than relying on regulators or other professionals. There is still room for development.

In sum, it is too much to argue that all OTC derivative transactions should be treated as kinds of contracts of utmost good faith. Most instruments lack the personal element that we have seen in the case of insurance policies. Even for those instruments which have some degree of personalisation and require a certain amount of good faith before the contract is made, it is arguable that there are other better ways of dealing with them than imposing a duty of utmost good faith and avoiding a contract for failure to honour such duties. After all, derivative instruments are based on contracts. If one party believes that a certain type of information is important, he might simply ask the other party about it or insert a special term to address the issue. If no inquiry is made and no such term inserted, why should we not rest with: *let the buyer be aware?*

### 3. *Guarantee and Credit Default Swap*

Lastly, let us consider the case of applying a duty similar to a guarantee contract to particular credit default swaps (CDS). As mentioned earlier, a guarantee contract and a standard CDS share some similarities as they both deal with the credit default of a debtor, where a guarantor, as a secondary debtor, pays off the debts of the principal debtor.<sup>86</sup> In a credit default swap, a risk buyer compensates the loss in value, usually by way of repaying to the risk seller the difference between the par value of the debt instrument (bonds or loans) and its current market price after default or by buying out the debt instrument from the risk seller. In this way, a CDS ensures that a bondholder (or the lender of a loan) can reclaim back the money to which he is entitled. If a guarantor has a claim on avoiding his guarantee contract when the principal debt is greatly different from what he knew,<sup>87</sup> could a risk buyer in

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*Kleinwort Benson Ltd. v. Birmingham City Council*, [1997] Q.B. 380 (C.A.); *Kleinwort Benson Ltd. v. Lincoln City Council*, [1999] 2 A.C. 349 (H.L.).

85. See Bezzina, *supra* note 81; see also Steven Edwards, *The Law of Credit Derivatives*, J. BUS. L. 617, 646 (2004).

86. For more thorough analysis of the accessory nature of a guarantee contract, see Johan Steyn, *Guarantees: the Co-extensiveness Principle*, 90 L.Q.R. 246 (1974).

87. Cf. *Associated Japanese Bank (International) Ltd. v. Credit du Nord SA*, [1989] 1 W.L.R. 255

a CDS enjoy the same claim?

In reality, it is rather unlikely that a risk seller would agree to take on the credit risks of a third party unless the instrument(s) requiring hedging were specified.<sup>88</sup> This would have two kinds of effects. On the one hand, since it is specified, the risk buyer just has to perform the contract as it is. If the risk buyer decides to take the credit risks associated with Bond A and if, unfortunately, Bond A is in default, the risk buyer should bear the fruits. It does not matter if the risk seller does not hold any Bond A or if he holds Bond B instead of Bond A as stated in the agreement.

On the other hand, a CDS could be synthetic or purely speculative (meaning no loans or bonds are actually held). In the case of a guarantee, such kinds of disclosure are important and necessary because the guarantor's obligation is closely linked to the principal obligation. If the principal obligation differs from what was agreed at the beginning, the extent of the guarantor's secondary obligation changes accordingly. The same rationale regarding disclosure does not hold in the case of a CDS. This does not mean that a risk buyer has no claim if the underlying credit obligation greatly exceeds what was expected — he may be able to seek remedies using the doctrine of mistake or misrepresentation. It is simply that guarantees and CDS are not comparable in terms of pre-contractual disclosure issues.

#### 4. *Summary*

In this part, we focused on the issue of whether risk trading contracts could be seen as another type of contract *uberrimae fidei* in which a duty of utmost good faith dictates a duty of disclosure. Apart from definitional issues relating to insurance and derivatives, we found that it would be difficult to extend the sort of duty of utmost good faith applied in insurance to the derivatives market. The inequality of knowledge that underlines the insurance disclosure rule does not necessarily exist in the case of other hedging instruments. We failed to find significant differences between derivative instruments and other commercial contracts, which have no utmost good faith requirement. However, we also noted that problems similar to those found in insurance may arise in the risk trading market if an instrument is linked to the risk buyer himself. More problems may arise as the market becomes more consumerised and individualised. Some of these

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(Q.B.).

88. This would be the case of a CDS being used to cover credit exposure on bond or loan. But if a CDS structure is employed to address the credit risk of another derivative transaction (e.g. an interest rate swap), the CDS then becomes a “swap guarantee” or a “market risk contingent credit default swap.” In this situation, the credit exposure that underlies the CDS becomes more dynamic than that of a conventional CDS. See DAS, *supra* note 77, at 156-58.

issues could be resolved by further examination of contractual parties rather than by the nature of the contract itself.

## V. SPECIAL RELATIONSHIP

Following above analysis, we will further examine whether there is a kind of special relationship between parties to a derivative transaction. We will start by discussing the use of contracts to control disclosure issues before a specific transaction is made. We will then consider whether the relationship between the two parties is of a kind that could raise a fiduciary relationship such that one party would have to disclose to the other party certain information in order to observe his fiduciary duties.

### A. *Risk Trading and Fiduciary Relationship*

Let us first determine whether risk trading contracts can automatically entail fiduciary duties such that one party (as a fiduciary) has to disclose material information to the other party before a transaction. Not every type of relationship is of the kind of fiduciary in nature. In general:

[t]he paradigm of the circumstances in which equity will find a fiduciary relationship is where one party, A, has assumed to act in relation to the property or affairs of another, B. A, having assumed responsibility, pro tanto, for B's affairs, is taken to have assumed certain duties in relation to the conduct of those affairs, including normally a duty of care.<sup>89</sup>

Fiduciary duties usually arise in a situation where one person is required to take care of the interests of another person or persons and where we expect him not to advance his own interests before those of the other party or parties.<sup>90</sup> Three types of relationships exemplifying the fiduciary relationship are the trustee-beneficiary relationship, principal-agent relationship, and director-company relationship. Trustee, agent, and corporate director have to serve the best interests of the beneficiary, the principal, and the company respectively.

Once a fiduciary relationship is proven to obtain, fiduciary duties consist of at least two aspects. On the one hand, "[t]he distinguishing

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89. *White v. Jones*, [1995] 2 A.C. 207, 271 (H.L.) (*per* Lord Browne-Wilkinson).

90. According to Finn, "the central idea [of fiduciary duties] is service of another's interests." Paul Finn, *Fiduciary Law and the Modern Commercial World*, in *COMMERCIAL ASPECTS OF TRUST AND FIDUCIARY OBLIGATIONS* 9 (Ewan McKendrick ed., 1992).

obligation of a fiduciary is the obligation of loyalty;<sup>91</sup> thus, the fiduciary should not put himself in a position creating a conflict of interest with the other party or put his own interests ahead of the other party's. On the other hand, a fiduciary owes a fiduciary duty of care to serve the benefits of the other party, the exact scope of which duty of care depends on the relationship between the two parties. The reasonable care expected of a corporate director might not be the same as that expected of the trustee of an estate; thus, the extent of a fiduciary duty of care should be decided on a case-by-case basis.<sup>92</sup> However, as far as information and disclosure are concerned, it may be argued that to observe his duty of care or to avoid a conflict of interest the fiduciary might have to disclose certain material information to the other party prior to a specific transaction.<sup>93</sup> The duty to report is also embedded in fiduciary relationship.<sup>94</sup>

The key is still to establish a fiduciary relationship in the first instance.<sup>95</sup> It should be noted that a bank-customer relationship is generally not considered a fiduciary relationship but only a contractual one.<sup>96</sup> However, it has been suggested that where a situation involves the trust and confidence of one party or where there is an assumption of responsibility, special relationships other than trust and agency might raise a fiduciary duty of care.<sup>97</sup> The US law also takes a similar position.<sup>98</sup>

Despite the fact that there is no clear definition of fiduciary relationship, we could draw a tentative conclusion that a fiduciary relationship requires "trust and confidence." From this point of view, it is clear that derivative instruments alone do not generally create the kind of relationship requiring trust and confidence. It is not in the nature of these instruments to require authority, management, or forwarding other people's best interests; neither

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91. *Bristol and West Building Society v. Mothew*, [1998] Ch. 1, 18 (C.A.) (per Millett LJ).

92. *Per* Lord Browne-Wilkinson, "[a]lthough the extent of those fiduciary duties (including duties of care) will vary from case to case, some duties (including a duty of care) arise in each case." *White v. Jones*, *supra* note 89, at 271.

93. *See e.g., Regal (Hastings) Ltd. v. Gulliver*, [1967] 2 A.C. 134 (H.L.).

94. *See Leitch v. Abbott*, (1886) 31 Ch.D. 374 (C.A.).

95. Nevertheless, to determine whether a person is fiduciary, we might have to resort to the nature of the fiduciary duties. In Finn's words, "[i]t is not because a person is a 'fiduciary' or a 'confidant' that a rule applies to him. It is because a particular rule applies to him that he is a fiduciary or confidant for its purposes." PAUL FINN, *FIDUCIARY OBLIGATIONS* 2 (1977). *See also Bristol and West Building Society v. Mothew*, [1998] Ch. 1, 18 (C.A.) (per Millett LJ).

96. *See generally* ALASTAIR HUDSON, *LAW ON FINANCIAL DERIVATIVES* § 7-30 (4th ed. 2006). *See also Foley v. Hill*, [1848] 2 H.L.C. 28. In *National Westminster Bank plc v. Morgan*, [1985] A.C. 686 (C.A.), the court held that a bank-customer relationship was not the kind of ordinary relationship that raised the presumption of undue influence. At 707 (per Lord Scarman).

97. *White v. Jones*, [1995] A.C. 207 (H.L.) (per Lord Browne-Wilkinson). *See also Woods v. Martins Bank Ltd.*, [1959] 1 Q.B. 55 (Q.B.); *United Pan-European Communications NV v. Deutsche Bank AG*, [2000] EWCA Civ. 166.

98. *See De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293 (2d Cir. 2002); *K3C Inc. v. Bank of America*, 2006 U.S. App. LEXIS 27437 (5th Cir. 2006).

does insurance or a sale. Thus, we could conclude that a risk trading contract does not automatically raise fiduciary duties. This is also the position taken by US judges to date.<sup>99</sup>

This paper does not argue that a fiduciary relationship may never arise between any given two parties. A fiduciary relationship may be established if a trust and confidence relationship is proved, but this could only be decided on a case-by-case basis. What we argue in this section is that risk trading contracts alone do not necessarily entail fiduciary duties, but we do not exclude the possibility that fiduciary duties might arise from the two parties' other dealings.

#### B. *Fiduciary Duties and Exchange Brokers*

Further to the above discussion, let us consider the relationship between an exchange broker and his client. In the context of exchange trading, traders who are not members of an exchange have to go through a firm or a person who is a member and who will place trades for him.<sup>100</sup> Usually the member trades on his own account, even though he is receiving orders from a customer. Therefore, although it may look as if the customer is trading on the futures market through a brokerage firm, there are, in fact, two parts to the transaction: one between the member firm in the exchange, and the other between the firm and the customer. For convenience, we may loosely call the member firm a "broker."<sup>101</sup> In this context, we may approach the information issue in several ways.

First, information could move from either side of the broker-client relationship. On the one hand, if the client holds material information that is unknown to the broker, this situation is similar to those we discussed in the previous sections. Since a customer could hardly be treated as a fiduciary to the broker, it would be difficult to require the client to disclose on the grounds of fiduciary duties.

On the other hand, the analysis will be different if it is the broker who holds material information and does not tell the client before the latter places an order. Since a broker deals with the customer's orders, an agency

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99. In *Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F.Supp.2d 118 (S.D.N.Y. 2000), a US judge also held that "a fiduciary duty does not arise in the normal course of an arm's-length business transaction. ... [C]ourts have held that a financial products dealer ... normally does not undertake a fiduciary duty when it acts as a principal in transactions with an institutional counterparty in which no trading discretion is conferred." At 150.

100. The number of traders who can commit trading directly in a futures exchange is limited by membership (often requiring a substantial membership fee). Those who are not members but who wish to trade in a futures exchange have to enter into a brokerage agreement with a member.

101. An exchange member could hire another exchange member to trade for him. A specialist floor trader might also conduct trades for another member firm. The relationship in these situations is similar to a broker-client relationship.

relationship could obtain between them that might raise fiduciary duties.<sup>102</sup> Even without financial regulation of the behaviour of financial brokers (if they are regulated persons),<sup>103</sup> there are certain common law rules on the relationship between parties as to the handling of orders and the movement of money or properties.<sup>104</sup> Thus, there is the possibility of raising fiduciary duties to deal with information issues in the broker-client relationship. It then depends on the scope of the duties owed by the broker. If a broker only handles orders for the client without giving any advice or being given any discretion, it is arguable whether the duty of the broker could include informing the client as to a piece of material information.<sup>105</sup> In contrast, if the client has authorised the broker to use his discretion when trading, there is a higher chance that the broker is under a duty to disclose relevant market information.<sup>106</sup>

Secondly, in a broker-client relationship, further bargaining power and investor protection concerns could arise. A client could be a sophisticated business entity who does not have membership in an exchange. He could also be an individual investor who wishes to hedge or speculate in the futures market. Thus, it would be false to assume that there is always unequal bargaining power between a broker and a client. On the other hand, the contract between a broker and a client could be a standardised form drawn up by the broker without any negotiation. Further concerns might come into play if a broker has greater bargaining power, which allows him to insert terms necessary to protect him from any information advantage.<sup>107</sup>

Thirdly, it would be a different story if a broker assumed the role of an investment adviser rather than merely a broker. It would be even more complicated if we took into account the law of negligence and the potential duty of confidentiality owed by the broker, who might have to take care in drafting his contract and in the wording of his advice to customers to avoid any exposure to liability.

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102. In *Brandeis Brokers Ltd. v. Black*, [2001] 2 LLOYD'S REP. 359 (Q.B.), Toulson J upheld the decision of arbitrators that Brandeis had an agency relationship (and thus fiduciary relationship) with Black, his client, even when Brandeis traded in the futures market as an undisclosed principal (for a discretionary account of Mr. Black). See *infra* 5.5.2.2 for more details of this judgment.

103. For example, the FSA Handbook, COBS 11 provides some rules to regulate how a broker/dealer should deal with a customer's order.

104. See *Stafford v. Conti Commodity Services Ltd.*, [1981] 1 LLOYD'S REP. 466 (Q.B.).

105. In *De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293 (2d Cir. 2002), the US court took the view that a broker for a non-discretionary account does not normally hold any fiduciary duty or additional duty to disclose to or advise his client.

106. Cf. *Brandeis Brokers Ltd. v. Black*, [2001] 2 LLOYD'S REP. 359 (Q.B.).

107. A similar line of analysis was taken in the US law. The client's level of sophistication is an essential factor when determining whether there is a fiduciary relationship between a broker and a client. Barbara C. Matthews, *Derivatives, Fiduciary Obligations and Codes of Conduct*, in SWAPS AND OFF-EXCHANGE DERIVATIVES TRADING: LAW AND REGULATION (Eric C. Bettelheim et al. eds., 1996).

## VI. INSIDER DEALING

If the above analysis shows that the mandatory disclosure system in securities regulations might not work well in the non-securities market, and that the duty of utmost good faith is not suitable for non-insurance risk trading contracts, there is still one type of non-disclosure that might be seen as wrong but is not addressed by common law remedies. Insider dealing (also called “insider trading”) has long attracted academic interest. The insider dealing rule does not directly impose a duty of disclosure; instead, the insider dealing rule prohibits an insider from using his information advantage before the information has been published in a proper manner. The rule is largely based on statute.

An insider dealing transaction is a transaction where an “insider” uses his privileged access to inside information to make profit on the market before this information is disclosed to the public. Insider dealing problems are usually discussed in the context of securities markets. For example, a typical case of insider dealing in the securities market would be if a director at Northern Rock sold his shares in the company ahead of a new financial report on Northern Rock’s performance, being aware that the report is much worse than the market expected. If, in contrast, he chooses to go long or short on NASDAQ futures, he is still profiting from his inside knowledge but he has crossed the line into the derivative market.

The same thing could also happen in the commodities market. Broadly speaking, any information advantage could lead to some kinds of insider dealing, whether it is related to securities or not. If the opportunistic buyer in *Laidlaw v. Organ* had been the agent of one of the representatives signing the peace treaty, he would have been using insider information for his own profit. Osama Bin Laden could likewise have made huge profits by making currency or oil transactions before or after the September 11 attack (if he had found a way to launder his money). Or, to give a rather more cinematic example, a person gifted with supernatural powers over the weather (such as in the movie *X-Men*) could earn a fortune simply by buying weather futures and using his powers to change weather patterns to his own advantage.<sup>108</sup>

Given the speculative nature of derivative instruments and the close

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108. Similar things could also happen to gambling contracts. For example, a horse owner knows that his horse has absolutely no chance of winning a race (for a reason not yet known to the public and which could influence the odds). Before the information is leaked, the owner could lay (or sell) odds in a betting exchange and thus win some money. In this horseracing story, the owner (as one party to a gambling transaction) knows something that is not known to the other party. The owner is apparently an insider and he uses his information to his advantage before the information becomes known to the other. The question is whether the owner has to disclose this information and whether, as far as our argument in this section is concerned, this is the kind of transaction that could be defined as a type of “cheating.”

connection with current financial markets, it is no surprise that insider dealing might extend from the traditional securities market to futures or other derivatives markets. However, it is not clear how far the insider dealing rule should and could address potential information problems. In this part, we will examine potential insider dealing problems by using derivative instruments. We will not limit ourselves to a narrow meaning of “insider dealing” in the stock market. In contrast, we will explore a broader range of circumstances wherein a person uses his inside knowledge unknown to other market participants to conduct risk trading.

#### A. *Current Laws and Underlying Theories*

Before moving on to some potential insider dealing problems in the hedging market, we should first understand what insider dealing means and, more importantly, why insider dealing is deemed wrong in the securities market. In the UK, insider dealing was already considered a criminal offence under the Criminal Justice Act 1993 (CJA 1993)<sup>109</sup> before the Financial Services and Markets Act 2000 (FSMA 2000) made it a kind of “market abuse.”<sup>110</sup> We should be aware that the CJA 1993 uses explicit terms like “insider” and “inside information” and limits criminal liability to dealings with securities, which include not only stock and bonds but also options, futures, and contracts for differences involving purchases or sales of securities.<sup>111</sup> On the other hand, the FSMA 2000 has a broader application without specific reference to “securities” or “insider.”<sup>112</sup> The FSMA 2000 makes it clear that the penalty imposed for market abuse does not make a transaction void or unenforceable.<sup>113</sup> Thus, insider dealing behaviour does not render a transaction void. However, the Financial Services Authority (FSA) might make a restitution order where necessary<sup>114</sup> and impose penalties for violators.<sup>115</sup>

In contrast, US law shows a different style. The foundation of the modern insider dealing rule in the US securities regulations lies in the anti-fraud provision in the Securities Exchange Act of 1934<sup>116</sup> and the SEC

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109. Criminal Justice Act, 1993, c. 36, § 52.

110. FSMA 2000 § 118. *See also* FSA Handbook, MAR 1.3.

111. Criminal Justice Act, 1993, c. 36, Schedule 2 (Eng.).

112. FSMA 2000 § 118. The FSA handbook broadly refers to insider dealing of “qualifying investment,” defined by the Treasury as all investments prescribed by the FSMA 2000 section 22 in recognised investment exchanges. FSA Handbook, MAR 1.3 and The Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001, SI 2001/996, Articles 4 & 5.

113. FSMA 2000 § 131.

114. FSMA 2000 § 382.

115. FSMA 2000 §§ 123 & 129.

116. Securities Exchange Act of 1934, 15 U.S.C. 78j (2000).



Rule 10b-5,<sup>117</sup> which make it unlawful to employ any manipulative or deceptive device (or any device, scheme, or artifice to defraud) in contravention of SEC rules and regulations. Thus, the US insider dealing law has a strong reference to “fraud,” without explicitly using the term “insider dealing” (or “insider trading”).

A breakthrough in insider dealing law occurred in the 1960s. The rule was largely developed by the Securities and Exchange Commission (SEC) and the US courts.<sup>118</sup> We should be aware that violation of the anti-provision of the Securities and Exchange Act of 1934 might grant victims private cause of actions to sue for damages.<sup>119</sup> A corporate director or officer might also have to disgorge his profits to the issuer company if he uses inside information to make profit.<sup>120</sup>

Regardless of the meaning of “inside information,”<sup>121</sup> the meaning of “insider” appears to determine how far insider dealing rules in the securities market can reach. Corporate directors, managers and employees are the most usual type of “insider.”<sup>122</sup> In both the UK and the US, a tippee, who receives tips from corporate insiders, is also liable for insider dealing.<sup>123</sup> We also expect professionals (such as solicitors or accountants) who have access to inside information not to use it before it is published.<sup>124</sup>

However, there are always some difficult boundary cases. In *US v. Chiarella*,<sup>125</sup> the court faced a situation where an employee of a financial printer somehow decoded the messages as to the target companies of takeover bids using his own skills. Should Mr. Chiarella be liable even though he was neither a corporate insider nor a professional? He did not even have a direct contractual relationship with the company (but only with his immediate employer).

This case raised a fundamental problem: why is insider dealing prohibited? One fundamental difficulty in forming the foundation for

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117. SEC Rule 10b-5, 17 C.F.R. 240.10b-5 (2008).

118. *See In re Cady, Roberts & Co.*, 40 SEC 907 (1961); *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968).

119. *See Superintendent of Insurance of New York v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

120. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. 78p(b). This section applies to corporate directors and officers when they use inside information to buy securities or securities-related instruments and when profits are realised within 6 months. The purpose of this section is to prevent “unfair” use of information.

121. *See* Criminal Justice Act, 1993, c. 36, § 56 (Eng.). It is also frequently called non-public material information in US judgments.

122. Criminal Justice Act, 1993, c. 36, § 57(2)(a)(i) (Eng.). *See also SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968).

123. Criminal Justice Act, 1993, c. 36, § 57(2)(b) (Eng.). For US law, *see Dirks v. SEC*, 463 U.S. 646 (1983); *Carpenter v. US*, 484 U.S. 19 (1987).

124. Criminal Justice Act, 1993, c. 36, § 57(2)(a)(ii) (Eng.). For US law, *see US v. O'Hagan*, 521 U.S. 642 (1997).

125. *Chiarella v. United States*, 445 U.S. 222 (1980).

prohibition of insider dealing is identifying the victims. The victims of an insider dealing scheme could be the company itself, shareholders, counterparties to the trading contracts, other outside investors, or the market in general. For each type of victim one might develop a theory to justify insider dealing rules. This paper does not claim to specialise in insider dealing theory, but it is necessary to understand certain concerns about insider dealing before continuing our analysis.

First, the special relationship between parties (notably the fiduciary relationship) is the basis of the insider dealing rule; thus, insider dealing might be seen to be wrong because the insider breaches his duty.<sup>126</sup> The drawback of this approach is obvious, as it cannot explain the application of the insider dealing rule beyond corporate directors and professionals (e.g. why a tippee is liable for insider dealing). Secondly, a wider view is that the insider misappropriates information that does not belong to him.<sup>127</sup> Further development of this line of thinking could extend to render the tippee liable.<sup>128</sup> Thirdly, one may further argue that inside information is a kind of protected property, such that an insider should not use it without the information having already been disclosed.<sup>129</sup>

Fourthly, if we look at the bigger scale, insider dealing might have implications for the market. Price and market efficiency are major concerns. There are already plenty of economic arguments about how quickly information can be reflected in the market in terms of price and how insider dealing influences the price of securities.<sup>130</sup> On the other hand, there are also arguments to the contrary, with some authors arguing that insider dealing might in fact push price toward a more accurate position.<sup>131</sup> If price is the major concern, it is the market and investors as a whole that are the victims. In contrast, it is arguable that it is the issuing company (whose information is exploited by the insider before being published) that is the victim because its information is misappropriated. But it is also arguable whether the company suffers any loss at all in this circumstance.

Fifthly, some commentators turn to a moral explanation of why insider

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126. *In re Cady, Roberts & Co.*, 40 SEC 907 (1961).

127. *US v. O'Hagan*, 521 U.S. 642 (1997).

128. David T. Cohen, *Old Rule, New Theory: Revising the Personal Benefit Requirement for Tippee/Tippee Liability under the Misappropriation Theory of Insider Trading*, 47 B.C. L. REV. 547 (2006).

129. Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443 (2001); Ian B. Lee, *Fairness and Insider Trading*, 2002 COLUM. BUS. L. REV. 119 (2002). See also Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and Prohibitions against Insider Trading: Why A Property Rights Theory of Inside Information Is Untenable*, 59 BROOKLYN L. REV. 149 (1993).

130. See *supra* note 6, at 80-85.

131. Frank Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 335.

dealing is wrong. In *Chiarella*, Justice Blackmun argued that insider dealing without disclosure is “inherently unfair.”<sup>132</sup> However, justifying the “fairness” argument also requires much deeper analysis than a mere statement that insider dealing is unfair.<sup>133</sup> The appeal of moral theories might lie in their flexibility; however, upon closer inspection such appeal may be found rather hollow because we still have to justify the ethical standpoint that a particular writer takes on a particular situation.<sup>134</sup> A more straightforward argument would be that counterparties to such insider dealing transactions are the victims as they suffer directly from a lack of market sensitive information.<sup>135</sup>

In addition, one may further argue that insider dealing is wrong (or unfair) because other investors do not have equal access to inside information.<sup>136</sup> This “equal access theory” could work in combination with other theories (e.g. fair dealing or property theory).<sup>137</sup> The swing in public policy against insider dealing would greatly influence how we formulate and interpret the insider dealing rule, particularly in grey area cases like *Chiarella*.

From a more practical point of view, how legislators and judges in each jurisdiction approach insider dealing transactions and construe the law certainly depends on statutory language. The US law makes strong reference to “fraud” because the US insider dealing rule comes from the anti-fraud provision in the Securities Exchange Act of 1934.<sup>138</sup>

In contrast, there is no use of the term “defraud” in UK law; the FSMA 2000 puts insider dealing under the heading of “market abuse,” which gives clues on how to deal with “insider dealing.” The way the FSMA 2000 determines the legal consequences of such kinds of market abuse (i.e. not avoiding a contract but imposing penalties or ordering restitution as remedies) suggests that the FSA focuses on the market as a whole rather than an individual corporation or counterparty. In addition, structuring insider dealing under “market abuse” has the advantage of avoiding the need to force all arguments into the mould of “fraud,” as in the US.<sup>139</sup>

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132. *Chiarella v. United States*, 445 U.S. 222, 248 (1980).

133. Easterbrook, *supra* note 131, at 323.

134. Gary Lawson, *The Ethics of Insider Trading*, 11 HARV. J.L. & PUB. POL’Y 727 (1988); response by Jonathan R. Macey, *Comment: Ethics, Economics, and Insider Trading: Ayn Rand Meets the Theory of the Firm*, 11 HARV. J.L. & PUB. POL’Y 785 (1988).

135. Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375 (1999).

136. This rule was first adopted by a US court but later rejected. See *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968).

137. See Lee, *supra* note 129.

138. See Securities Exchange Act of 1934 § 10, 15 U.S.C. 78j (2000).

139. See generally Alexander F. Loke, *From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the UK, Australia and Singapore*, 54 AM. J. COMP. L. 123 (2006) (looking at how the contours of insider trading liability evolved in the U.K., Australia and

In the end, we should be aware that the insider dealing rule was developed in securities regulations to regulate the securities market. If we move beyond the securities market, we may find similar concerns about price, unfairness, and even fraud in relation to potential insider dealing. However, there also exist certain difficulties, as we have to keep a balance between the common law non-disclosure rule and a more regulatory-style insider dealing rule. It is on this basis that we will continue our arguments.

## B. *Application to the Risk Trading Market*

### 1. *Securities-related Exchange Trading*

The concerns arising from insider dealing in the securities market might also be applied in the futures, options or other securities-related products traded on exchanges. Insider dealing by way of securities-related derivative instruments is already regulated in both the UK and the US.<sup>140</sup> The case for securities-related options is simpler: an insider can make profits by arbitraging the fluctuation of the option prices or between the current securities prices and the future option exercise prices; he may also make profits or avoid immediate loss by using his inside information to buy or sell single-name securities futures contracts (e.g. futures contracts for British Petroleum stocks).

However, making profits on the futures market is not as simple as buying and selling stocks or bonds in a securities exchange. Until the futures product matures, a trader does not really pay for the underlying assets (but only the margin). For example, if we borrow the facts from *SEC v. Texas Gulf Sulfur Co.*,<sup>141</sup> the TGF had some good news on discovering a new oil field. Before announcing this new discovery in a clear way, some directors traded the company's stocks on the market, and the directors were held to be responsible for insider dealing. If any one of these directors wanted to profit from futures trading using their inside information, he had to build up long futures positions and liquidate as soon as the information was published (assuming that the announcement of such information would have led to the rise of the TGF's stock price). Since technically he did not hold any valuable

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Singapore and the ramifications of these changing contours for insiders, investors, market professionals, and associated persons).

140. See Criminal Justice Act 1993 Schedule 2 (Eng.). In the US, the Securities Exchange Act has already included insider dealing by way of a securities-based swap agreement. See Securities Exchange Act of 1934 §10, 15 U.S.C. 78j (2000). "Security future," which generally means futures of a single stock, have been included in the definition of "security" under the Securities and Exchange Act of 1934 as well as the Securities Act of 1933 after the Commodity Futures Modernization Act of 2000.

141. *S.E.C. v. Texas Gulf Sulphur Co.* 401 F.2d 833 (2d Cir. 1968).

assets but only a contractual right to buy the underlying assets at the end of trading, we could hardly deem him to have made a profit unless the position is liquidated. This shows that a futures position is a contract that expires at a certain point of time in the future (by triggering the process of physical delivery or cash settlement). Moreover, we may also further compare the situation where the director does not buy company stocks but lands lying near the site of the new oil field. Should the directors disclose the information to the land owner (which would presumably increase the property prices)? In principle, the common law non-disclosure rule should apply (unless the court holds otherwise).<sup>142</sup>

In addition, more difficulties arise if an insider trades indices futures (such as the FTSE 100 futures). In order to establish that the insider used his inside knowledge to earn a profit in the index futures market, we have to establish the connections between the sensitive information and not only the price of the securities but also the movement of the futures market. Since an index might be influenced by many factors other than information concerning a single company, the causal link between a piece of information and the index might become problematic.

We should then consider why insider dealing by securities-related futures should be regulated as under current law. If the misappropriation theory is the basis, it probably does not matter much whether an insider trades in the spot market or in the securities-related futures market. After all, the insider is penalised because he misappropriates corporate information to gain his own profits for himself. Moral theories might also help to support this point. However, difficulties remain in determining the amount of damages or restitution to be attributed if an insider trades market index futures before a piece of material information is disclosed.

On the other hand, if using inside information in the securities-related futures market is not desirable because it could be seen as a type of market abuse or is a fraud on the market, further research is needed to establish the link between information and the prices of a specific futures product in order to explain the potential negative impact on the market. After all, since the futures prices reflect expectations for the future, more has to be done to establish the future “price integrity” than in the spot securities market.

## 2. *Commodity Transactions*

### (a) Some Problems

If we expand our framework beyond securities, it will be seen that

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142. See FRIED, *supra* note 33, Chapter 6.

scenarios similar to securities insider dealing may still occur in the commodities market. Something akin to the Bin Laden example we gave earlier could well occur in a big oil company, to the directors of such a company or any person receiving trading tips from these “insiders.” Information in the commodities market is as important as in the securities market.

There are several situations where commodity insider dealing could occur. First, an insider could arbitrage price differences in the spot market, in the futures market, or between spot and futures market prices. By comparison with the securities market, it is more difficult to make a fortune by arbitraging in the spot commodity market. Higher liquidity in the market is the key to making such a scheme viable. It is obviously easier to conduct commodities insider dealing on organised exchanges where a person can buy, sell, and liquidate transactions quickly and at lower costs. However, with the help of standardised documentation in commodities trading, and to some extent the use of clearing clauses (such as circle clauses), a trader may still earn price differences by way of spot market commodity trades. In addition, if, using inside information, a person buys a commodity (e.g. gold) and keeps it as long-term investment rather than arbitraging price differences within a short period of time, it is arguable whether this is a kind of insider dealing that merits punishment.

Secondly, insider dealing may occur if an insider uses inside information regarding the production of a commodity to make a profit.<sup>143</sup> For example, a leading agricultural company knows that the production of August crops will not be good this year. Before this production information is disclosed to the market, either the company itself or one of its directors uses this information to sell agriculture futures. In the securities market, the same scenario would constitute insider dealing.<sup>144</sup> Likewise, big universal banks may acquire significant inside knowledge about the various aspects of their banking business and use the information for speculative trading.<sup>145</sup>

Thirdly, one could use inside information for personal profit by taking a step ahead of a market participant’s transactions — this is sometimes called the problem of “front-running.”<sup>146</sup> Tips could range from the market

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143. Dan Morgan relates several stories about how a few dominant grain companies search production news from all around the world in order to grab a business opportunity. Grain merchants’ operations in the futures also raise certain concerns. See MORGAN, *supra* note 7, at 429.

144. Cf. *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968).

145. There situation entails a “Chinese Wall” issue. See *Frontier Justice*, THE ECONOMIST, Oct. 21-27, 2006, available at [http://www.economist.com/finance/displaystory.cfm?story\\_id=E1\\_RDVTRD](http://www.economist.com/finance/displaystory.cfm?story_id=E1_RDVTRD) (last visited Dec. 10, 2008).

146. Markham distinguishes three types of front-running in the commodity futures market: “(1) trading by third parties who are tipped on an impending block trade (“tippee” trading); (2) transactions in which the owner or purchaser of the block trade itself engages in the offsetting futures or options transaction as a means of “hedging” against price fluctuations caused by the block transaction

participant's hedging strategies to a bulky spot (or futures) transaction and could influence market prices in a significant fashion. For example, knowing that part of the Shell strategy is to sell Brent futures positions in bulk, an insider might sell Brent futures before Shell does and buy back positions after Shell has sold its futures (assuming that Shell's bulk trading would send futures prices down in the short term and no other factors were involved).

Fourthly, a more serious problem would occur if one tried to make a profit by creating a significant market event, which is not a remote possibility in a globalised society, given that the market prices for some major commodities (such as crude oil and currencies) are greatly influenced not only by the law of supply and demand but also by major economic and political events. A powerful trader might also corner the market to fuel up spot or futures prices so that he could make profit on his own speculative positions.<sup>147</sup> This does indeed enter the realm of market manipulation or market abuse rather than traders merely using their information to their own advantage.

Fifthly, insider dealing may well occur across different sectors, not just in a single market. Some big market participants might have interests in different products or industries, such that they are in a powerful position to use information acquired in one market for trading in another market.<sup>148</sup> For example, a particularly bad crop year in the US would affect not only domestic buyers and sellers but also foreign spot or futures markets, as merchants might seek supplies from somewhere outside the US. Prices of substitute raw materials could also rise if other traders turned to other alternatives.

In addition, two markets can be inter-connected even though, superficially, they appear to be unrelated. For example, the corn futures market has become a playground for many energy traders because corn is increasingly being used to manufacture ethanol.<sup>149</sup> The energy industry

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("self-front-running"); and (3) transactions where a broker with knowledge of an impending customer block order trades ahead of that order for the broker's own profit ("trading ahead")." Jerry W. Markham, "Front-running" — *Insider Trading under the Commodity Exchange Act*, 38 CATH. U. L. REV. 69, 71 (1988). The FSA Handbook defines front running/pre-positioning as "a transaction for a person's own benefit, on the basis of and ahead of an order which he is to carry out with or for another (in respect of which information concerning the order is inside information), which takes advantage of the anticipated impact of the order on the market price." FSA Handbook, MAR 1.3.3(2). For its text, available at <http://fsahandbook.info/FSA/html/handbook/MAR/1/3> (last visited Feb. 4, 2009).

147. For example, British Petroleum was subject to investigation for manipulative trading practices in the US. See Jeremy Grant et al., *BP's Aggressive Trading Culture Comes to Surface*, FINANCIAL TIMES, July 3, 2006, available at <http://www.ft.com/cms/s/0/c974b9f6-0aca-11db-b595-0000779e2340.html> (last visited Dec. 4, 2008).

148. For example, Morgan has a lively illustration of the cross-industry operation of Cargill, one of the biggest grain trading companies in the world. See MORGAN, *supra* note 7, at 230.

149. Kevin Morrisonin, *Corn Futures Trading Volumes Reach Record*, FINANCIAL TIMES, June 19, 2006, available at <http://www.ft.com/cms/s/0/99c9fb04-ffd3-11da-93a0-0000779e2340.html> (last

might feel the heat if corn prices were driven too high, and prices for ethanol would be affected. A bad crop year might also send shockwaves through the freight market, as shipping from the US might diminish in the future and thus also affect freight rate forwards/swaps.<sup>150</sup> In addition, a bad crop year would certainly influence the share prices of big agricultural companies (as well as the industry in general). This would again lead to the realm of insider dealing in securities.

(b) Discussion

We may analyse potential insider dealing issues in the commodities market in two dimensions: who uses the inside information and what are the purposes of using such inside information.

First, from the above scenarios, we might find that potential insider dealing in the commodities market is not limited to corporate insiders or tippees who know something about the company that is not yet known to outsiders. There is a chance that it is the company itself using inside information rather than a corporate insider using the company's information. This reflects the differences between the commodities market and the securities market. Normally, an issuer of securities would not buy and sell its own stocks or bonds circulated in the secondary market and, even if it did buy back its stocks, there are certain rules in company law or securities regulation that the issuing company has to follow.<sup>151</sup> Buying back its own shares might also raise market manipulation concerns and allow regulators to intervene.<sup>152</sup> Thus, in the securities market, usually we focus on insider dealing of corporate directors or other insiders.

In contrast, in the commodities market, it is open to manufacturers, producers and any corporate or non-corporate insider to trade at the same time. Both the source of information and the insiders who have access to the information could conduct trading with this inside information. Where a director or any other inside personnel uses his inside knowledge to make personal profits, this is similar to insider dealing in securities; thus, we may

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visited Dec. 4, 2008).

150. The maritime freight rate is subject to fluctuation much like commodities. Thus, there has evolved a forward freight rate swap to allow shippers to hedge against freight rate risk. Examples can be seen in *Dampskibsselskabet "Norden" A/S v. Andre & CIE SA*, [2003] 1 LLOYD'S REP. 287 (Comm. Ct.); *Erne Shipping Inc. v. HBC Hamburg Bulk Carriers GmbH*, 409 F.Supp.2d 427 (S.D.N.Y. 2006). It was once reported that a New York agent, who made a mistake while bidding on corn for his client, asked his client to delay reporting the sale or booking ships for a few hours so that he could manage to recover the losses he made (by his own mistake) in the futures market. This story shows that how the shipping industry is closely linked with international grain sales. See DAS, *supra* note 77, at 284-85.

151. See Companies Act, 2006, c. 46, § 658 (Eng.).

152. See generally AVGOULEAS, *supra* note 6, at 280.



attempt to apply the same line of analysis developed in securities regulation. However, where it is the generator of information that enters into trading using his own inside knowledge, there are more conflicts between the common law non-disclosure rule and the idea of prohibiting insider dealing in the financial market as a whole.

Secondly, the reasons for an insider dealing transaction might enter into the question. In the context of risk trading contracts, one person could make an insider dealing transaction for the purpose of hedging future losses as well as speculating on the market. If speculation is the sole purpose, this is more comparable to insider dealing in the securities market since it is closer to opportunistic behaviour that can be attacked on moral grounds. In contrast, since hedging is more or less established as a legitimate purpose,<sup>153</sup> it is arguable that there is nothing wrong with using unpublished material information to avoid one's own loss, especially when it is the company, rather than a director or any other corporate insider, who uses the inside information in trading.

We should also note that there is already a continuous duty of disclosure of material information to the market in securities regulation. Thus, it is natural to prohibit insiders from exploiting that information before it is published. In contrast, as regulation on commodities trading does not contain such a duty, why should we bother to ask people not to use his inside information if, in principle, they are allowed to take any information advantage? A balance must be made between the common law rule and the insider dealing rule imposed by statutes. The reasons why we perceive insider dealing as wrong will determine how important we find tackling insider dealing in the non-securities market.

As in the securities market, there are two lines of analysis we may follow. On the one hand, we could follow the line of price integrity. However, we should be cautious when comparing futures prices with spot market prices as there is no doubt that a piece of information could influence both the physical market and the hedging market (*Laidlaw v. Organ*<sup>154</sup> is a good example). However, a non-disclosure of inside information does not automatically mean that market prices are wrong.<sup>155</sup> A coherent line of analysis has to be made to fully justify a wrongful price theory in relation to

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153. In *City Index Ltd. v. Leslie*, [1992] Q.B. 98 (C.A.), Leggatt LJ stated that “[a]lthough before the [1986] Act came into force, contracts for differences were void, other contracts which are superficially similar were not. These were contracts entered into for a commercial purpose, such as hedging. Such contracts may result in no more than the payment of a difference. But because they were made for a commercial purpose, they are not void as wagering contracts.” At 112. For New York law, see also *Holberg v. Westchester Racing Association*, 53 N.Y.S.2d 490 (N.Y. App. Div. 1945).

154. *Laidlaw v. Organ*, 15 U.S. 178 (1817).

155. See Perdue, *supra* note 44, at 366.

commodity insider dealing.<sup>156</sup>

On the other hand, if insider dealing is not wrong because of its market implications but because the insider uses a piece of information that does not belong to him, we should consider whether the problem could be resolved in other ways. In a more typical insider situation, the source of the information might use existing legal tools, such as fiduciary duties or confidentiality duties, to restrain directors, officers, employees or any contracted persons from using that information. Why should we launch a regulatory scheme to address the problem of corporate insiders using corporate information in the commodities market if the problem could be solved by inserting a contractual term to allow the company to sue for damages?

Currently, the FSA takes a fine line in distinguishing insider dealing as market abuse and trading with legitimate business.<sup>157</sup> The FSA has provided some guidelines on whether, in using inside information, a person is pursuing legitimate business. To quote in full:

In the opinion of the FSA, the following factors are to be taken into account in determining whether or not a person's behaviour is in pursuit of legitimate business, and are indications that it is:

- (1) the extent to which the relevant trading by the person is carried out in order to hedge a risk, and in particular the extent to which it neutralises and responds to a risk arising out of the person's legitimate business; or
- (2) whether, in the case of a transaction on the basis of inside information about a client's transaction which has been executed, the reason for it being inside information is that information about the transaction is not, or is not yet, required to be published under any relevant regulatory or exchange obligations; or
- (3) whether, if the relevant trading by that person is connected with a transaction entered into or to be entered into with a client (including a potential client), the trading either has no impact on the price or there has been adequate disclosure to that client that trading will take place and he has not objected to it; or
- (4) the extent to which the person's behaviour was reasonable by the proper standards of conduct of the market concerned, taking into account any relevant regulatory or legal obligations and whether the transaction is executed in a way which takes into

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156. See AVGOULEAS, *supra* note 6, at 108-11.

157. FSA Handbook, MAR 1.3.7. For its text, available at <http://fsahandbook.info/FSA/html/handbook/MAR/1/3> (last visited Feb. 4, 2009).

account the need for the market as a whole to operate fairly and efficiently.<sup>158</sup>

This explanation appears to show that the FSA is trying to reconcile the common law and the market abuse rule in order to define the line between lawful business practice and market abuse conduct. The FSA is ready to allow a true hedging contract to stand even if inside information was used to make the hedging transaction. Insider dealing in the commodities market might be allowed if it is in line with the standards of market conduct (and thus no market “abuse”) or has no impact on the market (and thus no abuse of the “market”). Apparently, the more organised the market, the more likely that the financial regulator will enforce the relevant market abuse rules. However, it remains to be seen how far the FSA would extend the use of the insider dealing rule to risk trading contracts that take place outside the banking circle or organised exchanges. If such contracts are not touched by regulation, they will be governed by the common law rule, where one party might in principle enjoy his information advantage.

If a person intentionally stages an event to work market prices to his favour, this is probably more like market manipulation behaviour. To address this kind of conduct, a more comprehensive and focused market manipulation regulation might be better suited than a general prohibition on insider dealing. After all, market manipulation looks much more like straight fraud than mere non-disclosure.

Moreover, there might be concerns over the integrity and openness of trading if major participants worked the exchange and rules to their favour. Through such participants’ superior knowledge of the market, one might wonder whether “outsiders” were being treated fairly in the open market.<sup>159</sup> In this case, major market participants’ use of their inside knowledge might be subject to further scrutiny.<sup>160</sup> And one might further challenge the role an exchange could play in dealing with market manipulation or insider dealing.<sup>161</sup> In the off-exchange market, a further point might be the regulatory control (if any) of trade associations or non-profit organisations, which produce standard forms for the market.<sup>162</sup>

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158. FSA Handbook, MAR 1.3.10. For its text, *available at* <http://fsahandbook.info/FSA/html/handbook/MAR/1/3> (last visited Feb. 4, 2009).

159. Once it has been described that the futures market had a “club-like atmosphere.” JERRY W. MARKHAM, *THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION* 58 (1986). If this is the case, there could be suspicion of lapse of self-regulation by exchanges that might further enhance regulatory intervention.

160. *See* FSA Handbook, MAR 1.3, particularly the example given in MAR 1.3.21. For the text, *available at* <http://fsahandbook.info/FSA/html/handbook/MAR/1/3> (last visited Feb. 4, 2009).

161. *See* AVGOULEAS, *supra* note 6, at 229-34.

162. Caroline Bradley, *Private International Law-making for the Financial Markets*, 29 *FORDHAM INT’L L.J.* 127 (2005); Kevin E. Davis, *Production of Boilerplate: The Role of Nonprofits in*

Lastly, certain insider dealing problems could be related to relationships among parties. For example, a front-running problem might occur where a broker trades for his own benefit before he trades for a client's trading order.<sup>163</sup> If we turn to the private law side of the issue, front-running in the context of the broker-client relationship might raise the issue of breaching fiduciary duty (provided that a fiduciary relationship is established in the first place).

On the one hand, one argument to support a breach of fiduciary duty claim is based on the fact that a broker has to use information about his client's order to make front-running transactions. Thus, it is arguable that a broker breaches his duty of confidentiality by front-running. In *Brandeis Brokers Ltd. v. Black*,<sup>164</sup> Brandeis, the broker, was accused of breaching his fiduciary duty to Black, his client, by mis-pricing and front-running. The arbitral tribunal held that it is a "misuse of confidential information" if a "broker discloses to outside parties, or uses for its own purposes, confidential information in its possession about a client's positions, transactions or intended transactions" and that "[f]ront-running would be a particular form of misuse of confidential information."<sup>165</sup> Toulson J upheld the arbitral decision.

On the other hand, another argument is that a broker's front-running moves market prices before his client's order and thus puts his client in a less favourable place if a broker trades ahead of a bulky order. In an American case, *Dial*, the defendant, was accused of committing mail fraud in violation of a federal statute by trading ahead of a client's trading order in the Chicago Board of Trade.<sup>166</sup> The main issue was fraud rather than fiduciary duties. However, the Seventh Circuit Court also held that:

Dial, when he solicited his customers to participate in block orders, implicitly represented to them that he would try to get the best possible price. He could have gotten a better price by putting their orders in ahead of the orders he placed for his own accounts and those of his friends. In trading ahead of his customers without telling them what he was doing, he was misleading them for his own profit, and conduct of this type has long been considered fraudulent.<sup>167</sup>

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*the Production of Boilerplate*, 104 MICH. L. REV. 1075 (2006).

163. This kind of practice is already prohibited by the Financial Services Authority. FSA Handbook, MAR 1.3.2(2) and the example given in MAR 1.3.22. For its text, available at <http://fsahandbook.info/FSA/html/handbook/MAR/1/3> (last visited Feb. 4, 2009). See also FINANCIAL SERVICES LAW § 6.58 (Michael Blair & George Walker ed., 2006).

164. *Brandeis Brokers Ltd. v. Black*, [2001] 2 LLOYD'S REP. 359 (Q.B.).

165. *Id.* at 366.

166. *US v. Dial*, 757 F.2d 163 (1985).

In the end, Dial was held to have committed fraud. If we follow the above two judgments, it seems that it is accepted by both the UK and US court that a commodity futures broker breaches his duty of confidentiality or loyalty by front-running a client's order. We may also find that misappropriation or fiduciary theory might become the basis for regulation against front-running by a commodity futures broker.

### 3. *Credit Market*

We now turn to potential insider dealing and OTC transactions, starting first with the credit market. To take an example, a person learns from the director of a big company that the company might suffer a major credit default. Subsequently, that person (as a risk seller) chooses to enter into a CDS with a bank to insure against the credit risks of that company. Soon after, the default does occur and the person may earn some monies even without owning the bonds of the company (subject to the terms of the CDS). Even for a true hedger, such a manoeuvre could still earn him a lower fixed-rate for the CDS since the CDS rate would rise to reflect the new credit exposure after a default. Inside information could influence the credit market in the same way that arbitraging securities prices does.

Apart from the theories mentioned above, we could put forward two more arguments on the issue of potential insider dealing in the credit derivative market. On the one hand, perhaps what we dislike most is people behaving opportunistically in arbitraging information advantages. When one speculates on the credit market, one is actually trying to make a fortune from the misery of an issuer or a creditor. This kind of opportunistic conduct might easily invite negative remarks.

On the other hand, to use an argument similar to those used in insurance, if a person takes advantage of his prior knowledge of certain credit issues of a third party and buys protection with a lower rate from a risk buyer, one could argue that he is not acting in good faith.<sup>168</sup> Without additional help from regulators, we can only rely on the contract or common law doctrines such as fraud, misrepresentation or mistake. A duty of utmost good faith followed by a duty of disclosure might solve the problem; however, we have found no convincing reason to impose a duty of "utmost good faith" in our above analysis. The market abuse approach taken by the FSMA 2000 might be a more flexible way of dealing with this issue than the fraud theories developed in both securities regulation and commodities regulation in the US. Again, these issues might also be resolved through

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167. *Id.* at 168.

168. See also Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167, 191-92 (2007).

contractual terms; thus, arguably there is no need for the law to intervene as a party can protect himself by negotiating better contractual terms. In this circumstance, issues relating to bargaining power and the party's ability to negotiate terms to protect himself would come to the fore.

Lastly, the credit market could be closely connected with the securities market. For a CDS, this partly depends on how wide a credit event is defined in each credit derivative instrument. For a credit total return swap,<sup>169</sup> all the gains (including price appreciation) from the reference obligation (e.g. a corporate bond) are transferred from a risk seller to the risk buyer. If either party has inside knowledge about something that is bound to happen, they could actually make a profit through a total return swap, much like arbitraging in the securities market. The same might be argued for an equity swap.<sup>170</sup> It is not easy to estimate the probability of success regarding such manoeuvres in practice. Unless the credit event happens very rapidly and the first settlement date is not far off, it might not be easy for such a scheme to succeed. But however likely it may be, we could still recognise that an insider has a chance to use the growing credit market to earn private profit. He is still using corporate information, but he is not necessarily creating wrongful market prices (with regard to those securities). This might provide further challenges to financial regulators when the credit market booms.<sup>171</sup>

#### 4. *Other OTC Transactions*

In the end, we should consider the potential insider dealing problems raised by other cash-settled OTC derivative transactions. Given the variety of instruments and traders, it would be nearly impossible to exhaust the possibilities for using OTC instruments for purposes of insider dealing. For instance, it is not unthinkable that the major shareholder of a company might use its insider knowledge of the company's operations to enter into an equity swap. A company might also make a profit from having contracts for differences or equity swap before announcing a plan to take over another company whose shares underlie the contract for differences or swap.<sup>172</sup>

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169. Under a total return swap, one party (A) pays periodically to the other party (B) bond interests and any appreciation of bond prices, and B pays to A interests based on a market floating rate and any depreciation of the bond prices. See DAS, *supra* note 77.

170. In an equity swap, one party makes a fixed or floating interest payment on the basis of a notional amount plus any depreciation of an equity price or index, in exchange for the return on the equity price or index (including any appreciation of prices and distribution of dividends), calculated notionally in monetary terms. See DAS, *supra* note 47, at 81.

171. See Sarah Bowles & Darren Fox, *Credit Markets and Market Abuse*, 22 J. INT'L BANKING & FIN. L. 209 (2007).

172. In 1995, Trafalgar House plc had a series of equity swaps (structured as contracts for differences) on certain regional electricity companies before announcing a takeover for one of the electricity companies. Trafalgar House plc was accused of insider dealing, but was cleared by the

There could be several motives for using inside information in OTC transactions. On the one hand, an insider might wish to take advantage of his information and make a deal at a lower price — such a situation is similar to *Laidlaw v. Organ*<sup>173</sup> except that the information advantage is applied in a different type of trading. Whether an insider dealing transaction based on this motive is worth punishment as an abuse of market requires further clarification by judges and regulators.

On the other hand, a person might use his information advantage to make a straight profit. The current FSA insider dealing rules broadly cover “dealing” in qualified investment related investment on the basis of inside information. In one of the examples given by the FSA, the FSA would regard a director’s spread bet on securities prices of a company as insider dealing if the director placed his bet on the basis of the belief that undisclosed news about the company’s imminent takeover would increase the value of his shares.<sup>174</sup> If we follow this example, entering into a contract for differences (e.g. interest rate swap, spread bets etc.) on the basis of inside information might fall under the UK market abuse rule.

Again, we could see the contrast between the application of the common law non-disclosure rule and the market abuse/insider dealing rule in the context of OTC trading. The common law rule is restrained by the scope of insider dealing regulation. In other words, trading OTC derivative instruments with inside information might not be wrong except when it is recognised as an instance of market abuse.

### 5. Summary

In this part, we have noted that insider dealing problems might arise in the risk trading market. The insider dealing rule has largely been developed in the securities market, so where securities are involved, there should not be a problem in applying the securities insider dealing rule. In contrast, what concerns us here is insider dealing in non-securities related markets. To this end, we have found that commodities futures prices are not directly comparable with spot market prices, and thus price integrity arguments might be a persuasive way of extending the securities insider dealing rule to the commodities market. On the other hand, we face the difficulty of reconciling the common law non-disclosure rule and the idea of insider dealing. This is a policy decision, and Parliament or financial regulators should have the final say on how far a trader may enjoy advantages deriving

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Takeover Panel. See DAS, *supra* note 47, at 422-23.

173. *Laidlaw v. Organ*, 15 U.S. 178 (1817).

174. See FSA Handbook, MAR 1.3.20(1). For its text, available at <http://fsahandbook.info/FSA/html/handbook/MAR/1/3> (last visited Feb. 4, 2009).

from inside information. In addition, we also identified a source of potential problems in the credit market and noted that there might be some moral arguments against people speculating on other people's credit. Lastly, where a person intentionally creates an event to work market prices to his favour, this is not merely insider dealing but a deceptive or manipulative scheme. Such kinds of behaviour might be called "fraud" and should be taken in hand by regulators, if not by courts through other common law options.

## VII. CONCLUSION

In this paper, we have explored issues of pre-contractual disclosure for derivative instruments. Risk trading contracts strongly rely on all sorts of information as they deal with future uncertainties. Indeed, for every transaction there is a certain degree of asymmetric information. The problem is how the law tips the balance in different contexts. Our approach is to see whether risk trading contracts could fit into existing categories that require disclosure rather than creating a general duty of disclosure.

In common law, there is no general duty of disclosure before a contract is made. So a contractual party could take advantage of any information of which the counterparty is ignorant. However, this general rule is restricted by the law of deceit and misrepresentation: where any non-disclosure can constitute fraud or misrepresentation, the information holder has to disclose to avoid further liability.

There also exist several exceptions to the general rule, and it is on these exceptions that we can draw a comparison with risk trading contracts. First, we have seen that mandatory disclosure in the securities market cannot be extended to exchange-traded futures contracts (save where securities are involved) because of the nature of securities. With regard to commodity futures, it is impractical to impose similar duties on those who produce the underlying commodities (*cf.* issuers of stocks).

Secondly, there is also a duty of disclosure structured under a wider duty of utmost good faith for insurance contracts. However, we find this is less successful in risk trading contracts. On the one hand, it lacks a uniform definition of hedging, speculative or derivative instruments, such that any general duty could have a wider and more profound impact than intended. On the other hand, non-insurance risk trading contracts lack the inequality of knowledge issue underlying contracts of insurance. While the duty of good faith could play a role in filling the gap between fraud and the common law non-disclosure rule in insurance, we cannot draw the same comparison for most risk trading contracts. This is not to say that there could be no moral hazard issues in the derivative market. However, since the current market is still limited to transactions between sophisticated market participants, it is



less an issue because parties can address the problem in their contracts. Further problems may evolve in the future, should modern hedging or speculative contracts become more consumerised.

Thirdly, we have found that the prohibition of insider dealing has some impact on the issue of pre-contractual disclosure. The insider dealing rule does not really require traders to disclose information but prohibits them from using it. The insider dealing rule has already been the subject of various discussions and the underpinning theories of why insider dealing is wrong can determine how far we should go to deal with this problem. On the one hand, we have to be careful when drawing comparison between futures and spot prices. It is also hard to provide a comprehensive theory to distinguish the general rule of non-disclosure (as in *Laidlaw v. Organ*) from the insider dealing rule in securities regulation. On the other hand, we could also argue from a moral perspective against speculating on another person's information. The overarching concepts of "market abuse" or "market fraud" might provide a better basis for addressing information issues in the risk trading market. Nevertheless, there remains much to research before reaching a more complete conclusion.

Ultimately, our question is: where does one draw the line between a more lenient common law approach and additional regulatory disclosure rules regarding information problems in risk trading contracts? This might be a question that legislators and regulators have to consider in the future.

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