ADMINISTRATIVE PROCEEDING
FILE NO. 3-5230

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
STRATEGIC MANAGEMENT, INC.	:
(801-11009)	:
PREFERENTIAL BROKERAGE, INC.	:
(8-17210)	:
LEROY S. BRENNA	:

INITIAL DECISION

December 5, 1977
Washington, D.C.

Irving Sommer
Administrative Law Judge

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	:	

APPEARANCES: Cecil S. Mathis and John S. Daniels of the Fort Worth Regional Office of the Commission, for the Division of Enforcement.

Howard V. Tygrett, Jr., of Dallas, Texas, for Respondents.

BEFORE: Irving Sommer, Administrative Law Judge

These public proceedings were instituted pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(e) and 203(f) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("ICA") by order of the Commission dated April 19, 1977 ("Order"). The Order directed that a determination be made whether the above-named respondents committed various charged violations of the Exchange Act, the Advisers Act, and the Investment Company Act and regulations thereunder, as alleged by the Division of Enforcement ("Division"), and the remedial action, if any, that might be appropriate in the public interest.

In substance, the Division's allegations are that during the period September 3, 1975 through January 26, 1976 the respondents, Strategic Management, Inc., Preferential Brokerage, Inc. and Leroy S. Brenna, wilfully violated and wilfully aided and abetted violations of Section 17(e) of the Investment Company Act in that they caused Preferential Brokerage, Inc., an affiliated person of Strategic Investment Fund, Inc. to receive prohibited commissions from the Fund in connection with over-the-counter purchases of securities.

It is further charged that the respondents wilfully violated and wilfully aided and abetted violations of Section 17(a) of the Investment Company Act in that they caused Preferential Brokerage, Inc., an affiliated person and principal underwriter for the Fund, to knowingly sell securities to the Fund.

The respondents were further charged with having wilfully violated and wilfully aided and abetted violations of Section 22(c) of the Investment Company Act and Rule 22c-1 thereunder in improper pricing of the Fund's shares for purposes of sales and redemptions; and that the respondents wilfully violated and wilfully aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in connection with the offer, sale and purchase of Fund shares through the use of a prospectus which was materially misleading and omitted to state material facts.

Respondents appeared through counsel, who participated throughout the hearing. Successive filings of proposed findings, conclusions and supporting briefs were specified as part of the post-hearing procedures and timely filings were made by the parties.

The findings and conclusions herein are based upon the record and upon observation of the demeanor of the witnesses. Clear and convincing evidence is the standard of proof applied. 1/

1/ The Commission has traditionally employed the "preponderance of the evidence" standard of proof. In Collins Securities Corporation v. S.E.C., C.A.D.C., August 12, 1977, the Court held that in cases involving alleged fraud and potentially severe sanctions the higher "clear and convincing evidence" standard must be met. In the instant case, as to those charges either admitted or where the facts are not in dispute, i.e., charged under 17(a), 17(e) and 22(c) of the Investment Company Act of 1940, preponderance of the evidence was the standard of proof applied. However, it is to be noted either standard yields the same results as to these violations. (continued)

The Respondents

Strategic Management, Inc. ("SMI"), a Texas corporation located in Dallas, Texas, has been registered as an investment adviser pursuant to Section 203(e) of the Advisers Act since September 22, 1975.

Preferential Brokerage, Inc. ("PBI"), a Texas corporation located in Dallas, Texas, has been registered as a broker-dealer pursuant to the Exchange Act since July 27, 1972.

Strategic Investments Fund, Inc. ("SIF"), a Texas corporation located in Dallas, Texas is an open-end, diversified, management investment company which has been registered under Section 8 of the Investment Company Act since July 29, 1974.

Leroy S. Brenna ("Brenna") is president and chairman of the board of directors of SIF, president and a director of SMI, and owner of 77% of the common stock of SMI, and president and a director of PFI, and owner of 96% of the common stock of PFI.

Brenna exercises managerial responsibility in conducting the daily operations of SIF, SMI and PFI, including the selection of portfolio securities for SIF. SMI, PBI and Brenna are affiliated persons of SIF within the meaning of the Investment Company Act.[2/]

1/ (continued)
As to the fraud violations alleged under Section IID of the Order for Proceedings, clear and convincing evidence is the standard applied.

2/ Section 2(a)(3).

Investment Company Act Violations

Section 17(a)

Section 17(a) prohibits, absent an exemption, sales of securities or other property to a registered investment company by an affiliated person of such investment company, or by an affiliated person of such a person.

The record discloses and the respondents admit that on two occasions Preferential, acting as principal, sold securities to SIF. No application for exemption was made. Respondents further admit that Preferential did obtain and charged SIF a markup of $1084.50 arising out of these transactions.

Respondents contend that these were two isolated transactions which will not reoccur, with a "de minimus" effect on the price per share of SIF. Their contentions are wholly lacking in merit and are unavailing. The violations occurred.

Accordingly, respondents SMI, Preferential and Brenna are found to have wilfully [3/] violated Section 17(a) of the ICA, and that Brenna and SMI wilfully aided and abetted such violations.

3/ "Wilfulness" for purposes of these proceedings does not require that a person know that he is breaking the law, but only that there be an intent to perform the acts that resulted in the violation. Tager v. S.E.C., 344 F.2d 5 (2d Cir. 1965); Lipper v. S.E.C., 547 F.2d 171 (2d Cir. 1976).

Section 17(e)(1)

The Division contends, as the order charges that SMI, Preferential and Brenna wilfully violated and wilfully aided and abetted violations of Section 17(e) of the Investment Company Act in connection with the receipt by Preferential of brokerage commissions in connection with SIF transactions.

Section 17(e)(1) as pertinent here makes it unlawful for any affiliated person of a registered investment company, or any affiliated person of such person, "acting as agent," to accept any compensation for the purchase or sale of any property to or for such company, except in the course of such person's "business as . . . . broker." The record shows and respondents admit that Preferential received $22,866.75 in commissions for executing portfolio transactions for SIF during the period from September 3, 1975 through January 26, 1976.

The Division contends that respondents' conduct constituted wilful violations of 17(e)(1) since there was no "necessary brokerage function" performed by Preferential inasmuch as SMI, the adviser, was obligated to conduct trading services. I do not agree with the Division's position.

The record shows that Preferential has been registered with the Commission as a broker-dealer since July 27, 1972. It is regularly engaged in the brokerage business with a staff of twelve salesmen. Preferential was actively engaged in the

business of effecting transactions in securities for the SIF.

Preferential's mode of operation was to obtain quotations from a number of market makers prior to execution of the Fund's order for stocks in the over-the-counter market, and execute such orders at the best price. Additionally, Preferential provided appropriate confirmations, contacted the custodian where necessary concerning the transactions, and did record keeping. Notwithstanding the characterization of respondents' services as not "necessary," the record sustains a finding that Preferential was performing brokerage services for SIF.

Section 17 does not prohibit a person affiliated with a registered investment company from "acting as broker" in effecting portfolio transactions. To the contrary, ". . . at least by clear implication, [Section 17(e)] authorizes an affiliated person of a registered investment company to accept compensation for buying or selling property for the investment company in the course of the affiliated person's business as a broker." 4/ Such brokerage is clearly recognized by Section 17(e)(2) of the Investment Company Act which permits it to receive compensation for acting as a broker

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4/ Kurach v. Weisman, 49 F.R.D. 304, 307 (S.D.N.Y. 1970).

despite its Fund affiliation. The Division's reliance on Provident Management Corporation, 44 S.E.C. 442 (1970) and Steadman Security Corporation, Securities Exchange Act Release No. 13695 (June 29, 1977) is misplaced. In both cases, the Commission found that no actual brokerage services had been performed, and the retention of compensation for the performance of "ministerial acts" was violative of Section 17(e). Likewise the Commission's decision in First Multifund of America, Inc., Investment Company Act Release No. 6700 (August 26, 1971) does not support the Division's position. Thereto, the Division urged that no necessary brokerage activities were performed by the broker (also the investment company adviser) since the adviser carried out minimal functions in executing orders for the purchase of stocks for the Fund, and the Fund "could order the shares directly." Since the adviser was found to be carrying out brokerage activities (acting as broker), the Commission found no violation of Section 17(e). That over-the-counter securities are involved rather than listed securities does not detract from the general principle which permits a broker to collect compensation when "acting as broker" for an investment company with which he is affiliated.

The Division's further reliance on In the Matter of Thomson & McKinnon, Securities Exchange Act Release No. 8310 (May 8, 1968) and Delaware Management Company, Inc., Securities

Exchange Act Release No. 8128 (July 19, 1967) is mistaken. Both cases involve fraudulent interpositioning of broker-dealers resulting in increased costs to the Fund and shareholders. Since the respondents in both cases maintained active trading departments, execution of portfolio transactions could have been effectuated at lower prices without "incurring unnecessary brokerage costs and charges." In the instant case, the adviser has no trading department, and Preferential carried out the brokerage functions for SIF obtaining the most favorable execution under the circumstances.

Accordingly, it is concluded that the record fails to establish the charged violation of Section 17(e)(1) of the Investment Company Act in connection with Preferential's receipt of brokerage commissions.

Section 17(e)(2)

The Division contends, as the Order charges that SMI, Preferential and Brenna wilfully violated and wilfully aided and abetted violation of Section 17(e)(2) of the Investment Company Act in that Preferential received commission on SIF transactions which exceeded one per centum (1%) of the purchase price of the securities purchased.

Section 17(e)(2) of the Investment Company Act makes it unlawful for an affiliated person of a registered investment company "acting as broker" in connection with the sale of securities to such company, to receive from any source a

commission, fee or other remuneration which exceeds one per centum (1%) of the purchase price.

The record establishes, and the respondents admit, that the commissions charged by Preferential to SIF exceeded 1% of the purchase price of the securities acquired. Preferential contends it was entitled to a greater fee than 1% under 17 C.F.R. 270.17(e)-1, which permits a broker acting in over-the-counter transactions to collect a fee in excess of 1% if such remuneration does not exceed, as pertinent herein, ". . . the lowest brokers commission which is fixed as a minimum for effecting a transaction in listed securities of a similar type . . . on any national exchange located in the same city as the principal office of the broker . . . ." While acknowledging that as of May 1, 1975 there were no longer fixed commissions, respondents contend that since the above regulation is still in effect, they can continue to charge the previous minimum fixed commission rates, which in the instant matter exceeded 1%. The respondents are mistaken in their interpretation.

Under the regulation, fees greater than the 1% permitted by Section 17(e)(2)(c) are allowed in over-the-counter transactions only where such remuneration does not exceed the lowest brokerage commission which is "fixed" on a national exchange. Since fixed commissions were eliminated as of

May 1, 1975, the respondents are bound by the 1% limitation in 17(e)(2).

Accordingly, respondents SMI, Preferential and Brenna are found to have wilfully violated Section 17(e)(2) of the Investment Company Act, and that Brenna and SMI wilfully aided and abetted such violations.

Section 22(c)

The Division contends, as the Order charges, that SMI, Preferential and Brenna wilfully violated and wilfully aided and abetted violations of Section 22(c) and Rule 22c-1 thereunder in that they caused SIF to sell and redeem redeemable securities at prices not based on the current net asset value of such securities.

Section 22(c) authorizes the Commission to make rules and regulations applicable to registered investment companies and to principle underwriters of, and dealers in the redeemable securities of any registered investment company which prescribes the method or methods for computing prices upon purchase or sale of securities of any investment company.

Rule 22c-1 provides that the sale, redemption or repurchase of securities of registered investment companies shall be effectuated "at a price based on the current net asset value" which shall be computed daily. In computing the "current net asset value," Rule 2a-4 states that among others, "changes

in holding of portfolio securities shall be reflected no later than in the first calculation on the first business day following the trade date."

The record establishes that between September 5, 1975 and December 22, 1975, computations of the net asset value of the Fund was incorrect inasmuch as said value was calculated taking into account that Fund owned 3500 shares of Free State Geduld Mines, Ltd., when in fact only 3400 shares were held — accordingly, sales and redemptions were made at an incorrect net asset value.

Similarly, the record establishes that between April 28, 1976 and August 10, 1976, the net asset value of the Fund was incorrectly computed, using 3000 shares of East Diefonteen Gold Mining Co., Ltd. stock in the computation, when in fact 5700 shares were owned. Thusly, thereto sales and redemptions were made at an incorrect net asset value.

Respondents do not deny the charges, but firstly, attempt to characterize the resultant errors as minimal, and secondly state their accounting practices have been improved, and the error will not reoccur. Their attempted mitigation in no way detracts from their initial incompetence. The errors were of longstanding duration and remission of moneys owed to investors and to the Fund did not occur until after these administrative proceedings were instituted. Respondents further argue in mitigation that they could get no help from the Commission as to a remedy. This is rejected. Respondents

did not diligently press for a solution with their own counsel and/or accountant, and when they did, somewhat belatedly in 1977 (after proceedings were instituted) were able to find a solution.

Accordingly, respondents SMI, Preferential and Brenna are found to have wilfully violated Section 22(c) of the Investment Company Act, and that Brenna and SMI wilfully aided and abetted such violations.

Fraud Violations

The order for proceedings charged that Preferential and Brenna, aided and abetted by SMI offered and sold Fund shares through the use of a prospectus which was materially false and misleading in respect to the payment by the Fund of commissions to Preferential for stock purchases, and the manner in which portfolio transactions would be executed.

The Division argues that the prospectus was misleading in failing to disclose the brokerage commission paid to Preferential, and that management could have executed such transactions directly without use of Preferential, and payment to Preferential of "unnecessary commissions".

Respondents argue that the prospectus disclosed that Preferential "will be a major recipient of brokerage fees from the fund. . . ."

As previously found, the record demonstrates that Preferential "acted as broker" for SIF in the execution of portfolio transactions.

The obligations and duties of both Preferential and SMI are spelled out in the Fund prospectus, dated June 2, 1975.

The section entitled "Brokerage" (SIF prospectus, June 21, 1975, pages 21-2) states as follows:

> "The Advisory Agreement authorizes the investment adviser, subject to any directions which the Board of Directors may issue from time to time, to select brokers and dealers to execute Fund portfolio transactions in accordance with the following standards which are set forth in the Agreement.
>
> In all purchases and sales of securities for the portfolio of the Fund, the primary objective is to obtain the best price and execution. This will mean that the adviser will place orders for the purchase and sale of over-the-counter securities on a principal rather than agency basis and will place orders for the purchase and sale of over-the-counter securities with the principal market maker unless in the opinion of the Manager, a better price and execution can otherwise be obtained.
>
> The Agreement provides that when the adviser is satisfied that two or more brokers or dealers are equally able to provide the Fund with the best possible price and execution of the order, the adviser shall select brokers for the execution of the Fund's portfolio transactions from among those brokers who are equally able to provide best price and execution in the following order: (i) those brokers who provide quotations and other services to the Investment Adviser and the Fund; (ii) those brokers and dealers who supply research, statistics and other data to the adviser which relates directly to portfolio securities, actual or potential, of the Fund or which place the adviser in a better position to make decisions in connection with the management of the Fund's assets and portfolio, whether or not such data may also be useful to the adviser and its affiliates in managing other portfolios or advising other clients, in such amount of total brokerage as may be reasonably be required.
>
> Management anticipates that Preferential Brokerage, Inc., the distributor, will be a major recipient of brokerage fees from the Fund in the purchase and sale of portfolio securities. The rules of the National Association of Securities Dealers of which Preferential Brokerage, Inc. is a member allows offsets of brokerage commissions to institutional buyers. The Fund's Board has met and considered requesting such off-sets. Because of the cost of research and foreign communications to be borne by Preferential Brokerage, Inc., the Board made the decision that it was not in the best interests of the Fund to require such off-sets. In the event, however, that a better price or execution is, in the opinion of the investment adviser, obtainable through another broker, the order will be placed with such other broker as indicated above. It should be noted that certain principal persons of the investment adviser and distributor are the same. (See 'Distributor', below)"

The Division urges that the second paragraph of the brokerage section (see above) placed the obligation on management to execute Fund transactions, and that Preferential was improperly interposed, and paid unnecessary commissions. I do not believe there was a failure to disclose material facts as to this aspect of respondent's operations. The prospectus definitively states, "management anticipates that Preferential Brokerage, Inc., the distributor will be a major recipient of brokerage fees in the purchase and sale of portfolio securities." This is further emphasized in the "Distributor" section of the prospectus which again calls attention to the role of Preferential as follows, "Benefits will accrue to Preferential Brokerage, Inc., both from commissions on Fund portfolio transactions and as a result of its role as distributor." The clear implication of the prospectus together with the testimony of Dr. Brenna, president of both Preferential and SMI, and a Fund officer supports respondents' positions of the relationship between Preferential and the Fund, and the duties and obligations arising therefrom.

In my opinion, the record does not establish by clear and convincing evidence that the prospectus filed by SIF contained materially false and misleading statements with respect to commissions paid to Preferential for execution of Fund stock purchases, or the manner in which Fund portfolio transactions would be executed.

The order for proceedings further charges the respondents offered and sold shares of the Fund through a prospectus which was materially false and misleading in respect to the method used to determine net asset value per Fund share, and in failing to disclose that Preferential acted as a principal in the sale of securities to the Fund, for which it charged a markup.

The prospectus used by respondents in the offer and sale of shares in SIF did not disclose the facts with respect to the sale of securities to SIF by Preferential, acting as principal, nor that SIF was caused to sell and redeem redeemable securities at prices not based on current net asset value, in wilful violation of the antifraud provisions of the Securities Acts. The respondents ". . . engaged in transactions which violated statutory provisions designed to prevent inside self dealing, an abuse which Congress specifically recognized as having an adverse effect upon the public interest and the interest of investors." 5/ The occurrence of the admitted violations and the surrounding circumstances "were material facts of which prospective investors should have been informed". I conclude based on the record and the admissions of respondents, that Preferential

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5/ Imperial Financial Services, Inc., 42 S.E.C. 717, 728 (1965).

and Brenna, aided and abetted by SMI wilfully violated the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

Public Interest

The remaining issue concerns the remedial action which is appropriate in the public interest with respect to respondents.

The Division urges that the registration of SMI as an investment adviser be revoked, and that SMI, Preferential and Brenna be barred from association with any investment company; in addition, it asks that the broker-dealer registration of Preferential be temporarily suspended, and that Brenna be temporarily suspended from association with a broker-dealer.

In support of these severe sanctions, the Division refers to the breach of fiduciary duties by respondents in their violations of Section 17 of the Investment Company Act, and their violations of the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The Division further calls attention to the failure of the respondents to return profits "unlawfully obtained" to the Fund.

Respondents urge that the imposition of sanctions in this case would not be in the public interest and is not

necessary. In support thereof, respondents state that procedures have been instituted to insure that computation of "current net asset value" will be correct; that both the Fund and its investors have been repaid amounts due them arising from previous pricing errors, and that Preferential which acted as principal in dealing with the Fund in two transactions, would not follow such action again. While they admit a brokerage commission charge of over 1% (1.3% according to their records) in violation of Section 17(e)(2) of the Investment Company Act, respondents urge that they acted in good faith considering the ambiguities attendant upon and the general confusion occurring with the advent of negotiated commissions, and their interpretation of 17 CFR 270.17e-1. Finally, respondents assert that they have already been seriously penalized through the adverse publicity which reduced Fund sales.

The respondents were fiduciaries of SIF and as such owed it undivided trust and fidelity. They were under a duty to make full disclosure of all pertinent information. The violations found constitute a serious breach of trust. I conclude that the imposition of a substantial sanction is necessary in the public interest and for the protection of investors. However, upon a consideration of all the facts and circumstances herein, I do not find that

it is necessary in the public interest to impose the severe sanctions requested by the Division. I have taken into consideration among others, the fact that respondents have instituted strict accounting procedures to prevent future pricing errors, and have given assurance there will be no further transactions wherein Preferential acts as a principal in dealing with the Fund, these being two isolated cases involving overseas purchases. Furthermore, mitigating respondents' offense in these transactions is the fact that the record does not evidence deliberate intent to violate the law. I have also considered that the respondents' misinterpretation of the regulations regarding the percentage of commission they were lawfully entitled to, contributed to the violation of 17(e)(2). Moreover, as respondent suggest, the adverse publicity attendant upon the institution and trial stages of these proceedings will serve as a further sanction, and induce a more careful adherance to the high ethical and fiduciary standards of conduct owed to the Fund, its shareholders and the investing public. Upon careful consideration of the mitigative factors offered by respondents and of the opposing views of the Division, it is concluded upon the record herein the registration of SMI as an investment adviser be suspended for ninety days, that SMI, Preferential and Brenna be suspended from association with any investment company for ninety days, that the registration of Preferential as a

broker and dealer be suspended for ninety days, and that Brenna be suspended from association with a broker and dealer for ninety days.[6/]

Accordingly, IT IS ORDERED

1. That the registration of Strategic Management, Inc. as an investment adviser under the Investment Advisers Act, be and hereby is, suspended for a period of ninety days following the effective date of this order.

2. That Leroy S. Brenna be, and he hereby is, suspended from being associated with an investment adviser for a period of ninety days following the effective date of this order.

3. That the registration of Preferential Brokerage, Inc. as a broker-dealer be, and hereby is, suspended for a period of ninety days following the effective date of this order.

4. That Leroy S. Brenna be, and hereby is, suspended from being associated with a broker or dealer for a period of ninety days from the effective date of this order.

5. That Leroy S. Brenna, Strategic Management, Inc. and Preferential Brokerage, Inc. be, and they hereby are, suspended from being associated in any capacity with a registered investment company for a period of ninety days following the effective date of this decision.

6/ All proposed findings and conclusions submitted by the parties have been considered, as have their contentions. To the extent such proposals and contentions are consistent with the initial decision they are accepted.

This Order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Rules of Practice.

Pursuant to Rule 17(f) of the Rules of Practice, this initial decision shall become the final decision of the Commission as to each party who has not, within fifteen days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c) determines on its own initiative to review the initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.

Irving Sommer
Administrative Law Judge

Washington, D.C.
December 5 , 1977