ADMINISTRATIVE PROCEEDING
FILE NO. 3-7446

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	)
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KINGSLEY, JENNISON, MCNULTY & MORSE, INC., et al.	)
	)
	)

INITIAL DECISION

Washington, D.C.
November 14, 1991

Max O. Regensteiner
Administrative Law Judge

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APPEARANCES: Robert D. LaFramenta and Karen Matteson, of the Commission's Los Angeles Regional Office, for the Division of Enforcement.

Carol Goodman, Russell L. Allyn, Christine C. Franklin and Murray L. Simpson, of Thelen, Marrin, Johnson & Bridges, for respondents.

BEFORE: Max O. Regensteiner, Administrative Law Judge.

I. INTRODUCTION

In these proceedings pursuant to Sections 203(e) and 203(f) of the Investment Advisers Act of 1940 ("the Advisers Act"), the issues for consideration are (1) whether, as alleged by the Division of Enforcement, Kingsley, Jennison, McNulty & Morse, Inc. ("KJMM"), a registered investment adviser, together with or willfully aided and abetted by Richard Kingsley ("Kingsley"), one of its principals, willfully violated various provisions of the Advisers Act and rules adopted thereunder by the Commission, and (2) if so, what, if any, remedial action under that Act is appropriate in the public interest.

Following hearings, the parties successively filed proposed findings of fact and conclusions of law and supporting briefs, and the Division filed a reply brief. The findings and conclusions herein are based on the preponderance of the evidence as determined from the record and upon observation of the witnesses.

The Respondents

KJMM, based in San Francisco, has been a registered investment adviser since 1977. Its business has been concentrated on managing portions of the portfolios of large pension funds; it was, and is, a "single style" firm specializing in growth stocks. In 1985, the year during which the relevant events occurred, the market value of assets under its management ranged as high as $785 million. At all times from the firm's inception, Kingsley, one of its founders, has been one of its principal officers. During 1985 he was chairman of the board, chief executive officer and owner of about ten percent of KJMM, and, according to his own testimony, "had the ultimate responsibility for the firm." (Tr. 1-95).[1] At the present time,

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[1] The transcript for the fourth and last day of the hearing (volume 4) is incorrectly paginated; the page numbers overlap those in volume 3. Hence, in order to avoid confusion, citations to the transcript are both to volume and page number. By way of example,

Kingsley is still chairman and a substantial shareholder of KJMM; James Morse, another founder, is president and CEO. Kingsley, who is fifty-nine years old, has an undergraduate degree in economics and accounting as well as an MBA degree. Prior to the formation of KJMM, he was affiliated with other companies in investment advisory, securities research and portfolio management capacities.

The Allegations

The Division alleged that respondents willfully violated (or aided and abetted violations of) certain of the Advisers Act's antifraud provisions (Sections 206(1) and (2)) as well as certain reporting and disclosure provisions (Sections 204 and 207 of the Advisers Act and Rules 204-1 and 204-3). The allegations pertain to services which were provided to KJMM by Financial Selected Services, Inc. ("FSS") and James Blair, an FSS principal, in connection with respondents' hiring of one Philip W. Jonckheer and his subsequent training, and the manner in which KJMM paid for those services. According to the allegations, the services could have been purchased either for cash or with directed commissions. Here, payment was made in directed commissions or so-called "soft dollars," i.e., payments derived from brokerage commissions paid in connection with securities transactions entered into by KJMM for its clients' accounts. The Division alleged that KJMM directed a total of $31,960 in client commissions to FSS, of which Blair received over $19,000, and that, had payment been made in cash, KJMM would have had to pay about $17,000. It further alleged that the services KJMM acquired from FSS related to marketing techniques and were outside the "safe harbor" of Section 28(e) of the Securities Exchange Act of 1934 ("the Exchange Act") for "research and brokerage services," and that

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page 240 in the transcript of day 2 of the hearing would be cited as "tr. 2-240."

the payment for those services with client soft dollars constituted a breach of respondents' fiduciary duty. In addition, the Division alleged that, contrary to applicable requirements, respondents failed to disclose to clients or to the Commission the services received or the soft dollar payments. In their answer, respondents denied any violations.

The Statutory and Rule Provisions at Issue

Section 203(e) of the Advisers Act, as pertinent here, authorizes the Commission to impose any of specified sanctions on an investment adviser if such action is in the public interest and the adviser has willfully violated any provision of the Act or any rule thereunder. Section 203(f) has parallel provisions for persons associated with investment advisers. As noted, the Division charged respondents with violations of antifraud and reporting and disclosure provisions of the Act and related rules. The antifraud provisions in question are Sections 206(1) and (2) which make it unlawful for an investment adviser, by use of the mails or facilities of interstate commerce, "(1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client." The reporting and disclosure provisions cited by the Division are Section 204 of the Advisers Act and Rules 204-1 and 204-3 thereunder as well as Section 207 of the Act. Section 204 requires investment advisers to make records, furnish copies thereof and make reports, all as prescribed by Commission rules. Rule 204-1, as here pertinent, requires prompt amendment of the Form ADV (the adviser registration form) if information therein becomes inaccurate in a material manner. Rule 204-3 ("the brochure rule") requires an investment adviser to furnish a disclosure statement to prospective clients when entering into an advisory contract. The disclosure statement, containing information concerning the adviser's background and business practices, may take the form either of a

copy of Part II of its Form ADV or of a written document containing the same information.[2] Section 207 of the Advisers Act makes it unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report, or willfully to omit to state in any such application or report any material fact which is required to be stated therein.

As noted, another statutory provision referred to in the Division's allegations is Section 28(e) of the Exchange Act, enacted as part of the Securities Acts Amendments of 1975. While this provision may not be as central to the issues herein as the allegations suggested, it nevertheless remains an important aspect of the case. As here pertinent and in substance, Section 28(e)(1) provides that a person who exercises investment discretion with respect to an account (as KJMM did with respect to its clients' accounts) shall not be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of his having caused the account to pay more than the lowest available commission if such person determines in good faith that the amount of the commission is reasonable in relation to the value of the "brokerage and research services" provided. Section 28(e)(3) defines the types of services that fall within the quoted phrase. In a release issued soon after the enactment of Section 28(e), the Commission summarized the background and legislative history of that provision as follows:

Before the elimination of minimum exchange commission rates on May 1,

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[2] The rule also requires advisers annually to deliver or to offer in writing to deliver a written statement meeting the requirements of the brochure rule. In its release accompanying adoption of the brochure rule, the Commission stated that the rule does not specifically require advisers to furnish a revised document to each client every time a material change occurs, since that obligation is within the adviser's general fiduciary duty to his clients. Investment Advisers Act Release No. 664 (January 30, 1979), 16 SEC Docket 901, 906.

> 1975, many money managers chose brokers on the basis of superior execution and research services. Many brokerage firms had developed special research services as a means of competing for institutional business, and some money managers and brokers were concerned that, with the advent of competitive rates, money managers might be seen to be violating fiduciary duties if they caused a beneficiary's account to be charged more than the lowest commission available for a particular transaction and that that development would jeopardize the availability of research. The Congress concluded that general fiduciary principles did not contemplate that the lowest commission rate would necessarily be in the beneficiary's best interest, and it adopted Section 28(e) in order to assure money managers that, under a system of competitive commission rates, they might use reasonable business judgment in selecting brokers and causing accounts under management to pay commissions.

(Interpretations of Section 28(e) of the Securities Exchange Act of 1934, Securities Exchange Act Release No. 12,251 (March 24, 1976), 9 SEC Docket 259, 260).

In another release issued ten years later, the Commission referred to the fiduciary principle in question as being that a fiduciary cannot use trust assets to benefit himself, noting that the purchase of research with soft dollars, even if used for the benefit of the client, could be viewed as also benefiting the money manager in that he was being relieved of the obligation to produce the research himself or to purchase it with his own dollars. (Interpretive Release Concerning the Scope of [S]ection 28(e) of the Securities Exchange Act of 1934 and Related Matters, Securities Exchange Act Release No. 23,170 (April 30, 1986), 35 SEC Docket 905, 906). The Commission went on to state that in adopting Section 28(e), the Congress acknowledged the important service broker-dealers provide by producing and distributing investment research to money managers.[3] The Commission has also stated that Section 28(e)(1) does not establish a legal standard the violation of which

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[3] In its 1972 Policy Statement on the Future Structure of the Securities Markets, 37 Fed. Reg. 5,286 (1972), the Commission had stated, among other things, that the providing of investment research is a fundamental element of the brokerage function for which the bona fide expenditure of the beneficiary's funds is completely appropriate.

is a breach of fiduciary duty, but rather provides a "safe harbor" under certain circumstances. (Report of Investigation in the Matter of Investment Information, Inc., Securities Exchange Act Release No. 16,679 (March 19, 1980), 19 SEC Docket 926, 931).

Section 28(e)(2) authorizes the Commission to adopt rules prescribing disclosure of policies and practices regarding payment of commissions to be made by a person exercising investment discretion. When Form ADV, the investment adviser registration form, was revised in 1979 to require, among other things, narrative disclosure of information relating to brokerage placement practices, the action was based in part on Section 28(e)(2). (Investment Advisers Act Release No. 661 (January 30, 1979), 16 SEC Docket 901, 912, n.5).

II. OUTLINE OF CONTENTIONS

As further discussed below, the principal disputed issues relate to the nature of the services provided by FSS and Blair to KJMM, the adequacy of respondents' disclosure of those services and of the soft dollar arrangements with FSS, and the appropriate legal analysis. The Division contends, in substance, that the services furnished by FSS -- consisting of Blair's interview of Jonckheer, his evaluation of the latter's qualifications for the position of KJMM's director of client services and certain training of Jonckheer after he was hired for that position -- were designed simply to enhance KJMM's ability to market its money management services to existing and prospective clients; were beneficial only to KJMM; and did not constitute "research" within the meaning of Section 28(e)'s safe harbor provision. The Division further contends that KJMM's use of client commissions to pay for these services constituted a breach of the fiduciary duty owed to its clients and created a conflict of interest that needed to be, but was not, disclosed. With respect to the alleged violations of both the antifraud and disclosure provisions, it urges that the disclosure

concerning brokerage allocation in KJMM's Form ADV and in brochures furnished to clients was inadequate in terms of disclosing the arrangements between KJMM and FSS.

Respondents, on the other hand, contend that the antifraud provisions in question do not cover a breach of fiduciary duty, that being an area committed to state regulation, and that the alleged conflict of interest was of a purely hypothetical nature. They further contend that the services in question provided substantial client benefits and in part fell within the safe harbor. In addition, respondents urge that there has been no showing of "paying up" or other actual harm to clients, as required for a finding of antifraud violations. With reference to the disclosure which KJMM made in its Forms ADV and in client brochures concerning its brokerage placement practices, respondents take the position that the services provided by FSS and the amount of commissions in question were not material, and that the disclosure that was made was comprehensive and complied with Commission regulations.

III. FINDINGS OF FACT AND CONCLUSIONS

The Soft Dollar Transactions and Arrangements

Blair was not only a principal of FSS, but was also a part-time West Coast registered representative of Goodrich Securities, Inc. ("Goodrich"), a registered broker-dealer located in New York. This association enabled Blair, and through him FSS, to share in brokerage commissions and thereby to receive soft dollar compensation for their services. Goodrich cleared on a fully disclosed basis through Bear, Stearns, Inc. In order to pay FSS for its services and pursuant to FSS's instructions, KJMM placed transactions in client portfolios with Bear Stearns for the credit of Goodrich. Bear Stearns executed the transactions, retained 25% of the commission for its execution and clearing services, and remitted the balance to Goodrich, which in turn remitted 60% to Blair. This commission

split was in effect for all business brought in by Blair, regardless of whether soft dollar arrangements with firms such as KJMM were involved. KJMM directed a total of $31,960 in client commissions to Bear Stearns for the credit of Goodrich. Of this amount, Blair received $19,176 and Goodrich $4,794. If the FSS services in question had been purchased with cash, KJMM would have had to pay half of the soft dollar amount, or $15,980.

The transactions which generated the commissions involved some thirty-five accounts. For each of these accounts, the commissions paid in those transactions constituted less than 1% of total commissions paid in 1985. To put the amount of commissions involved in an over-all context, KJMM paid total brokerage commissions of about $4.1 million in 1985. During that year, KJMM placed over $58 million in orders with Bear Stearns, including the transactions at issue, and paid over $154,000 in commissions in transactions executed through Bear Stearns.

An issue that cropped up repeatedly in these proceedings is whether there was any "paying up" in the transactions under consideration. That phrase refers to paying more than the lowest available commission in order to obtain research or other services. The Division claims that it is irrelevant whether there was paying up here, and that in any event respondents have not proven that there was no paying up. Respondents take the opposite positions. On the question of relevance, they refer to the asserted absence of paying up as part of their argument that there was no injury to clients. They also urge relevance in connection with the materiality of the FSS services as related to the question of disclosure. These relevance issues are addressed below. It is clear, however, that the question of whether there was paying up is at the least relevant to the issue of the appropriate sanction.

I find the evidence persuasive that there was no paying up in the transactions at issue. The record shows the following: James Morse, who in 1985 was KJMM's president

with responsibility for compliance matters, testified that in 1985, as in other years, KJMM had a policy that the trader was to obtain the best execution possible and that there was to be no paying up.[4] Kingsley also testified that the firm had a strict policy against paying up.[5] Morse further testified as follows: He reviewed the trading blotter on a daily basis, with a view among other things of determining compliance with that policy. In 1985, it was KJMM policy not to pay commission rates higher than a 50% discount from the so-called "Mayday rates," i.e., the rates in effect on May 1, 1975 when fixed rate commissions were abolished. This policy applied whether or not soft dollar payments were involved. Morse further testified that he considered Bear Stearns to be one of the top firms for executing orders. While he told the trader about the soft dollar commitments, she was not given a goal that she had to meet. In the case of the trades in question, she knew that over a period of time, she was to place a certain amount of business with Bear Stearns for the credit of Goodrich "when everything else was equal." (Tr. 4-649). According to Morse, the commission rates paid on the transactions at issue were competitive. On a number of the trades the commission rate ranged from 7¢ to 8¢ a share, representing about an 80% discount from Mayday rates. On other trades the rates were higher, but, according to his testimony, those rates were justified by the time and effort the broker put into the transactions and were still within the firm's policy of obtaining at least a 50% discount from

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[4] Morse, like Kingsley, has had broad experience in the investment industry. Prior to joining KJMM in 1977, he was, among other things, a partner in charge of the research department and subsequently of the investment advisory department of a major New York Stock Exchange firm and later head of Bank of America's investment subsidiary with ultimate responsibility for the management of about $6 billion in assets.

[5] As noted below, KJMM's Form ADV in 1985 and 1986 stated in effect that there was no paying up in situations where services were obtained for soft dollars.

Mayday rates. Lee Pickard, respondents' expert witness, testified that the rates paid by KJMM to Bear Stearns in the transactions under consideration "were certainly within the range of normality and competitive at that time." (Tr. 1-161).[6] Pickard further testified that in 1985 Bear Stearns was one of the firms that could provide best execution.

John Goodrich, president of the Goodrich firm, testified that to the best of his knowledge, the commissions that Bear Stearns charged in 1985 on transactions placed for the credit of Goodrich were the same regardless of whether they involved soft dollar payments or not. He further testified that in fact Bear Stearns would not know whether a particular transaction involved soft dollars. In addition, Goodrich testified that the 60% that went to Blair may have been an unusually high percentage, but that he felt giving Blair that much was the best way to establish a West Coast presence. Pickard testified that there was nothing unusual about the commission split arrangement among Bear Stearns, Goodrich and Blair, and that this arrangement did not indicate that KJMM paid higher commissions because FSS also provided it with services. On the basis of the testimony cited above, which I credit, I reject the Division's argument that respondents have failed to establish that there was no paying up.

The Services Provided by FSS/Blair

At the outset, it should be noted that in essence FSS was Blair's creature; thus, references herein to FSS and Blair are used interchangeably. FSS provided services to KJMM on three occasions in 1985 that are at issue in this proceeding. In February, Blair

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[6] Pickard is a former director of the Commission's Division of Market Regulation who, both in that capacity and in his extensive private practice experience, has been deeply involved in regulating and counselling with respect to soft dollar arrangements and related issues.

met with Jonckheer for the purpose of interviewing and evaluating the latter for the position of KJMM's director of client services. In June, Jonckheer, who by that time had been hired by KJMM as vice-president and director of client services, attended a personalized training program. And in December, Jonckheer attended an FSS seminar together with a number of other persons. As noted, KJMM paid a total of $31,960 in soft dollars for FSS's services.[7]

As indicated previously, the Division maintains that the services provided by FSS to KJMM were not "brokerage and research services" within Section 28(e)'s safe harbor provision, were intended to enhance KJMM's ability to market itself to potential as well as existing clients, and were beneficial only to KJMM.[8] Respondents, on the other hand, contend that some of the services were in fact "research" and that the services provided substantial client benefits.

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[7] The total figure includes $486 for Blair's expenses incurred in connection with a meeting between him and Kingsley in June 1985. That meeting and the related soft dollars are not a subject of the allegations herein. A June 1985 letter from Blair to Kingsley gives a breakdown of the soft dollar costs of the different services provided or agreed upon as of that time: $12,200 for the February meeting, $18,000 for the June program, and $486 for the above-mentioned meeting. (Div. Ex. 52). These figures add up to $30,686. Since total soft dollar payments were $31,960, a difference of $1,274 is left for the December seminar. The record contains no direct evidence concerning the cost of that seminar.

[8] The Division also argues that whether or not services fit the definition of "research services" under Section 28(e) is irrelevant if the services remain undisclosed. This is an oversimplification, however. For one thing, as discussed below, less detail may be required for disclosure of research obtained for soft dollars than for other services so obtained. Moreover, in view of the fact that Congress, in enacting Section 28(e), looked with favor on broker-dealers providing research to investment managers, the whole approach to research services necessarily is more benign than to other kinds of services.

Events Leading to the Retainer of FSS

From 1983 to 1984, KJMM experienced a period of growth that nearly doubled the size of its assets under management. Kingsley and his colleagues felt that the firm's ability to service its clients "was beginning to be impacted negatively." (Tr. 4-426). As a result, KJMM retained a consulting firm, Greenwich Research Associates, to conduct a survey of KJMM's clients, to solicit input on "[w]hat they wanted from us, what they were getting, how they valued what they were getting." (Id.).

The results of the survey confirmed Kingsley's concerns: "[The clients] concluded . . . that we were good managers, but that we were uneven in our presentations as between managers. . . . [T]hey needed more feedback uniformly on both what we were doing in the portfolios perspectively and what we had hoped to do in the immediate future." (Tr. 4-431). In January 1985 Greenwich provided KJMM with recommendations on how the firm could develop "first-rate client relationships" through a client "service strategy" centered on periodic review meetings with clients and also including "a disciplined program of account reports" and "a prompt and reliable response to inquiries and requests for information." (Resp. Ex. 67). The primary objective of the review meetings was to provide clients with assurance that KJMM was managing their portfolios competently and in accordance with their objectives. Greenwich pointed out that the purpose of a service strategy was to build good client relationships and that it would "increase your share of each client's total business through above-average cash flow when results are good, while minimizing your loss of business during periods of unsatisfying performance." (Id.).

Kingsley followed up by issuing a memorandum to KJMM employees setting forth a client service strategy that incorporated Greenwich's recommendations. In addition, the firm decided further to implement those recommendations by creating the new position of

director of client services. Jonckheer was hired to fill the position and was also given the title of vice-president. Jonckheer, who had a B.A. from Harvard and an M.B.A. from Stanford and was 32 years old at the time, had been employed since graduation by a corporation, principally in implementing an acquisition program. He had had no experience in the investment management business. KJMM's partners had met Jonckheer and liked him, but decided to get an evaluation from Blair before hiring him. Before founding FSS, Blair had been director of client services for a major investment manager. As part of their disagreement over the nature of the services provided by FSS, the parties have different views as to the nature of FSS's business at the time in question. The Division relies on an FSS "1985 Report" which describes the firm's primary function as helping institutional investors in the marketing of their services, by strengthening marketing systems that integrated marketing, sales and client service activities. Respondents stress statements in FSS's Form ADV that referred to its giving of seminars structured to assist investment professionals in the application of various methods of security analysis. The record indicates that the firm's activities included different types of programs.[9] In any event, however, the issue here is the nature of the services actually provided to KJMM rather than the manner in which FSS described the range of its services.

The February Meeting

Blair met with Jonckheer over the course of two days in February 1985. KJMM paid for Blair's services and his expenses by directing $12,200 in commissions pursuant to the

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[9] While it is true, as respondents urge, that the statements in the 1985 Report are hearsay, by its nature the Report, a copy of which was contained in KJMM's files, is of a trustworthy nature. (Cf. Rule 804(b)(5) of the Federal Rules of Evidence). By contrast, the statements in FSS's Form ADV appear to be confined by the way the items of the form are phrased.

method previously described. According to Kingsley, the purpose of the meeting was two-fold: Blair was to evaluate Jonckheer and determine whether or not he was suitable for the new position at KJMM; in addition, he was to educate Jonckheer regarding the investment management industry in general and KJMM's position in that industry in particular. The record indicates that this is what in fact transpired.[10] After the meeting, Blair reported to Kingsley his impression of Jonckheer, including his conclusion that the latter was well suited for the position. As noted, Jonckheer was hired; he began working at KJMM in May 1985.

The June Program

The June program, lasting a week, was an individualized program for Jonckheer at FSS's offices. KJMM directed commissions totalling $18,000 pursuant to the method previously described. Jonckheer testified that there were three phases involved, the first two apparently involving a continuation of what had been started in February. In the first phase of the program, Blair provided him with a general description of the investment management industry. The second phase involved an in-depth discussion of KJMM's investment philosophy and style. And the third phase focussed on the development of a description of that investment philosophy and style, so as to, in Jonckheer's words, "assist our clients in making . . . rational asset allocation decisions." (Tr. 2-355). Jonckheer explained that this referred to the decisions of clients as to how much of their portfolio they wanted to entrust to a particular investment management firm. In his 1987 investigative testimony, Jonckheer elaborated somewhat on what transpired at the June meeting.[11] He

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[10] Blair died in 1986. Therefore Jonckheer is the only person who could give a first-hand description of what transpired at the February meeting and at the June program.

[11] Respondents object to reliance on the investigative testimony of Kingsley and Jonckheer. Their arguments on this point, and my ruling rejecting them, are contained in Part IV of this

pointed out that, based on what he had learned during his employment at KJMM, he was able to explain to Blair the firm's philosophy, style and process of investing. This led in turn to Blair's assisting him in developing a presentation or "story" for use in marketing as well as client service that clearly articulated that philosophy, style and process. (Div. Ex. 93 at 42). Jonckheer referred to this as "a comprehensive marketing and client service package" for the firm. (Id. at 34). And he characterized the presentation to existing clients as retention selling. As part of the June program, Jonckheer gave a presentation of the KJMM "story" to Blair or someone else associated with FSS. He denied, however, that the purpose of the program was to assist him in making a more effective presentation to clients and prospective clients. Rather, he stated, "the underlying reason was to develop the foundation for a description of our investment style and philosophy so that we could continue to fine tune that description, through discussions that I was expected to have with the investment professionals back in the office." (Tr. 2-401). Subsequent to the program, Jonckheer, with the aid of other KJMM personnel, developed a brochure which, according to Kingsley, "represented the foundation for client service and marketing reviews." (Div. Ex. 17).

Jonckheer's testimony ties in with his testimony that his principal responsibilities at KJMM were to coordinate client service and marketing activities. He explained that his client service activity involved achieving consistency in the periodic reports made by the portfolio managers to clients in terms of the firm's philosophy and style, and that his marketing activity was to assure consistent presentations to prospective clients. As part of his duties, he answered questionnaires from prospective clients, attended meetings of the

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decision, infra.

firm's investment strategy group so as to be conversant with developments respecting investments, and called on prospective clients. Kingsley testified as follows as to his understanding of the June program and its purpose:

> So many of our clients, particularly in the pension area where your committee changes over time, five years later you may only have one person who was involved out of a ten person committee who actually hired the firm and knew why they hired them and the particular style and everything. So it's mandatory on our part to keep reselling the firm, if you will, to our existing clients, making sure they knew how we fit in their mix of managers, what our style was. You can separate out new prospecting from existing client base, but from our perspective it's all part and parcel of the same thing, retention selling, new selling. We needed to obviously develop a more coherent approach, a more professional approach in that way.

(Div. Ex. 87 at 59).

The December Seminar

The final service provided by FSS was a three-day seminar in December 1985, entitled "Marketing Strategies for Sales Success" and attended by some twenty persons. Jonckheer's testimony is to the effect that he saw this seminar as an opportunity to give his presentation before a critical audience which would critique both content and style of the presentation, and that that was his primary reason for attending. The FSS brochure announcing the seminar stated that the theme was "winning," that is, the critiques of the participants' sales presentations were designed to assist investment marketing professionals in increasing their "new business win ratio." (Div. Ex. 28). All attendees would be able to videotape a sales presentation for critical review by Blair and other FSS personnel, and some attendees would have the opportunity to compete to manage a portion of an "account" by making a "live" presentation to a "finals" committee of plan sponsors. (Id.). Other seminar materials in evidence also indicate that the lectures and workshops were designed to assist the attendees in improving their sales and marketing

skills. (Div. Exs. 3 and 27). Topics for discussion included the mechanics of making marketing and sales presentations, and effective use of visual aids, brochures and letters. The creation and review of the video presentations were an important part of the seminar.

The Services in Relation to Section 28(e)

Section 28(e)(3), insofar as pertinent here, specifies that a person provides "brokerage and research services" insofar as he "(A) furnishes advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities" or "(B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts."[12] In its 1976 Release interpreting Section 28(e), the Commission, quoting the Senate Report on the 1975 Amendments, stated that "the touchstone for determining when a service is within or without the definition of Section 28(e)(3) is whether it provides lawful and appropriate assistance to the money manager in the carrying out of his responsibilities." (Securities Exchange Act Release No. 12,251 (March 24, 1976), 9 SEC Docket 259, 260). The Commission further stated that the safe harbor did not protect "products and services which are readily and customarily available and offered to the general public on a commercial basis." Following an extended staff re-evaluation of the latter standard, the Commission concluded in 1986 that it was difficult to apply and unduly restrictive in some circumstances, and that uncertainty about the standard may have impeded money managers from obtaining, for commission dollars, goods and services they believed important to the

[12] Subsection (C) deals with brokerage services and is not pertinent here.

making of investment decisions. (Securities Exchange Act Release No. 23,170 (April 30, 1986), 35 SEC Docket 905, 906-07). As a result, it withdrew the 1976 standard and adopted a revised standard: "the controlling principle to be used to determine whether something is research is whether it provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities." (Id. at 907). This standard differs in substance from the general 1976 standard only in the addition of the words "investment decision-making" and appears to me to be merely a refinement of that standard.

Judged by either the 1976 or 1986 standards, the services provided by FSS, with possible minor exceptions, did not fall within the definition of "research services,"[13] since they did not assist KJMM in the making of investment decisions. Respondents, as noted, only contend that "some" of the services provided by FSS constituted "research services." There is no serious contention that this was true for the Blair interview of Jonckheer in February. While Pickard testified that to the extent the interview session was devoted "for instance, to assisting Mr. Jonckheer in being able to coordinate client policy, or client reporting, it may be within Section 28(e), but I can't measure that with any degree of precision," (tr. 1-182-83), nothing in the record indicates that such assistance was given. Moreover, I cannot agree with the suggestion that assistance in the coordination of client reporting constitutes a "research service" within Section 28(e). The June program and December seminar were used primarily to assist Jonckheer in developing a proper

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[13] In the terms of the 1976 standards, the services provided by FSS were "readily and customarily available and offered to the general public on a commercial basis." That standard was still in effect in 1985. However, because the Commission in effect disowned it the next year, I am not relying on it in this decision.

description of KJMM's investment philosophy and style as well as to assist him in developing an effective oral presentation of that philosophy and style. The purpose of the training he received was to facilitate both the retention selling aspect of client service as well as marketing to prospective clients. It may be that in certain respects information was imparted to Jonckheer falling within the "research service" definition. Along those lines, Pickard pointed to certain topics listed in the brochures for the June program and December seminar, which he felt could fall within the safe harbor. He was not aware, however, as to whether and to what extent those topics were actually discussed. In any event, these were at best minor aspects peripheral to the basic thrust of the sessions as described above. There is also some evidence to the effect that the process of focussing on and tightening the description of KJMM's investment approach assisted the firm in developing a more disciplined approach to portfolio management which actually improved investment returns. To the extent this was true, however, it was no more than an incidental by-product of Jonckheer's training.

Respondents maintain that KJMM's clients derived great benefits from the improved presentations resulting from FSS's training of Jonckheer. For example, Kingsley testified that clients were provided with a better description of what KJMM was doing and therefore were able to make better decisions regarding their portfolios. He also testified that as a result of what Jonckheer learned, the firm and its portfolio managers were able to focus more clearly on the criteria used to make investments; that this process made them better managers; and that clients benefited as a result. Putting aside the fact that some of the training was clearly designed to promote sales to prospective clients and accepting the points made by Kingsley, the fact remains that the principal beneficiary of improvements in the way KJMM was operated was KJMM itself. Going back to the recommendations of

the Greenwich firm, which initiated the process under consideration here, improved client service was designed to retain, or even to increase, assets under management. It clearly was not appropriate to use client assets, as distinguished from KJMM's own funds, to pay for the services in question.[14]

KJMM's Disclosure

The adequacy of KJMM's disclosure regarding the FSS services and the soft dollar payments therefor has been placed in issue by the Division's contentions regarding the alleged antifraud violations as well as by those allegations that charge violations of reporting and disclosure provisions. It is the Division's position that respondents were required, but failed, to disclose the particulars of the soft dollar arrangements in KJMM's Form ADV or a promptly filed amendment thereto as well as in disclosure statements delivered to KJMM's clients.

As of 1985, when the soft dollar arrangements with FSS were in effect, the instructions for Item 11 ("Investment or Brokerage Discretion") in Part II of Form ADV read in relevant part as follows:

> If applicant . . . determines . . . the broker or brokers through whom, or the commission rates at which, securities transactions for client accounts are executed, describe on Schedule F how brokers will be selected to effect securities transactions and how evaluations will be made of the overall reasonableness of brokerage commissions paid, including factors considered in these determinations. If the receipt of products or services other than brokerage or research services is such a factor, this description should specify them. If the receipt of research services is such a factor in selecting brokers, this description should identify the nature of such research services.

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[14] It is true that analytically, research also serves to improve the performance of an investment manager and yet, under Section 28(e), it may be purchased with soft dollars. The difference, as previously noted, results from the fact that Congress made a determination that it was desirable to continue the provision of research by brokers to investment managers.

(Resp. Ex. 68). In an amendment to its Form ADV filed in February 1985, KJMM gave the following response to Item 11:

> When applicant places orders for the execution of portfolio transactions for client accounts, applicant will allocate such transactions to such brokers and dealers for execution on such markets, at such price, and at such commission rates as in its good faith judgment will be in the best interest of the client's account. The primary objective in the placement of all security transactions with specific brokers is to obtain the best execution possible. Although every effort is made to negotiate the best brokerage commissions, it is possible that from time to time a lower commission might be available from another broker. Relevant factors considered in negotiating brokerage commissions include, but are not limited to, execution capabilities, research and other services provided by such brokers or dealers not only directly to client portfolios but also which are expected to enhance the general portfolio management capabilities of the applicant. Clients are advised of this situation in the advisory agreement and are aware that it is not always possible to demonstrate that such factors are of a direct benefit to their account. Certain clients require us to direct various amounts of brokerage commissions to specific brokers.
>
> The reasonableness of brokerage commissions paid is evaluated by frequent surveys of a number of leading investment brokers to ascertain the general competitive level of commission rates for execution of security orders.
>
> Applicant has obtained certain services provided by investment brokers where there was an understanding for direction of certain amount of brokerage transactions; however, in every case, the fees required were satisfied only with brokerage commissions on transactions that would normally be made for the account in the absence of such fees and at equally competitive rates. During 1985 it is expected that approximately 30% of non-directed brokerage commissions will be used to obtain computer related equipment, research and information for the benefit of all our clients.

(Div. Ex. 35).

Under a revision of Form ADV effective January 1, 1986, Item 11 of Part II became Item 12, which provides in part that if the value of products, research and services given to the investment adviser was a factor in selecting brokers, "any procedures the [adviser] used during the last fiscal year to direct client transactions to a particular broker in return for products and research services received" must be described. Aside from this, the required

disclosure is essentially the same under the 1986 instructions as under the previous ones.[15] When it filed an amended Form ADV in March 1986, KJMM made the same disclosure regarding brokerage allocation as set forth above, merely substituting the year 1986 for 1985 in the final sentence.

Pursuant to Rule 204-3, the "brochure rule," KJMM delivered a copy of Part II of its then current Form ADV to clients at the outset of the advisory relationship. No amended material was delivered to clients, at least not with respect to the answer to Item 11.

Discussion of, and Conclusions Regarding, Alleged Violations

While soft dollar arrangements outside Section 28(e)'s safe harbor do not automatically constitute a breach of fiduciary duty, it is fundamental under the Advisers Act that an investment adviser has a fiduciary obligation to act in the best interests of his clients, which would preclude using his client's assets to benefit himself, and that he must disclose to his clients all material information concerning actual or potential conflicts of interest that might interfere with his giving disinterested advice.[16] It is the Division's position that respondents' interest in generating soft dollars to obtain services which were of benefit to them created a conflict with the interests of the KJMM clients which needed

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[15] See Securities Exchange Act Release No. 23,170 (April 30, 1986), 35 SEC Docket 905, 909, n.31: "Item 12 of the new uniform Form ADV mirrors Item 11 of the superseded form and has remained substantively the same since its adoption in 1979."

[16] See Securities Exchange Act Release No. 23,170 (April 30, 1986), 35 SEC Docket 905, 909 (citing S.E.C. v. Capital Gains Research Bureau, 375 U.S. 180, 190-92 (1963)).

to be but was not disclosed, thereby violating Sections 206(1) and (2) of the Advisers Act.[17] The Division places primary reliance on the Supreme Court's decision in S.E.C. v. Capital Gains Research Bureau, 375 U.S. 180 (1963), including the Court's statement that the Act "reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser -- consciously or unconsciously -- to render advice which was not disinterested." (Id. at 191-92 (citation omitted)).[18] Further in its decision, the Court, referring to the practice of the respondent there involved of secretly trading on the market effect of his own recommendations

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[17] The Division disclaims seeking findings against respondents simply for a breach of fiduciary duty resulting from the adviser's use of client assets (the brokerage commissions) for its own benefit. Hence, respondents' arguments to the effect that the Commission lacks jurisdiction to impose sanctions based on alleged breaches of fiduciary duty and that Section 206 of the Advisers Act does not proscribe such breaches are beside the point. The fact that in the Investment Company and Advisers Acts Congress enacted specific provisions relating to breaches of fiduciary duty and conflicts of interest does not lead to the conclusion urged by respondents that it could not have intended to include such conduct in the conduct prohibited by Section 206's general antifraud provisions. See Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 1 (1979), where the Supreme Court stated that Section 206 established federal fiduciary standards to govern the conduct of investment advisers, and that the Advisers Act's legislative history left no doubt that Congress intended to impose enforceable fiduciary obligations. 444 U.S. at 17.

Citing the House Report on the 1975 Amendments, respondents argue that Congress did not express the view that the use of soft dollars to pay for services would violate the Advisers Act. H.R. Rep. No. 123, 94th Cong., 1st Sess. (1975), p. 95. However, the portion of the Report they cite does not support the argument, particularly when consideration is given to a sentence omitted in respondents' brief. Rather, that portion merely reflects the position, codified in Section 28(e), that paying up for research should not be precluded.

[18] This statement is not dictum, as urged by respondents, but is central to the Court's decision in the case.

("scalping"), and the conflict of interest that was involved, stated that an investor seeking the advice of a registered investment adviser "must, if the legislative purpose is to be served, be permitted to evaluate such overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving 'two masters' or only one, 'especially . . . if one of the masters happens to be economic self-interest.'" (Id. at 196 (citation omitted)). Echoing the Supreme Court's pronouncements, the Commission, in Kidder, Peabody & Co., et al., 43 S.E.C. 911, 916 (1968), stated that:

> The Advisers Act was aimed at eliminating conflicts of interest between an investment adviser and his clients . . . [W]henever trading by an investment advisor raises the possibility of a potential conflict with the interests of his advisory clients, the investment adviser has an affirmative obligation before engaging in such activities to obtain the informed consent of his clients on the basis of full and fair disclosure of all material facts.

Respondents urge that the alleged conflict here was of a theoretical or hypothetical nature and that the disclosure that was made in KJMM's Form ADV was complete and accurate. With respect to the conflict, respondents assert that in fact decisions to trade clients' securities were unrelated to the soft dollar obligations to FSS. Morse testified that in most instances a KJMM portfolio manager who decided to buy or sell merely gave a trade ticket to the firm's trader and did not know what broker would be selected to execute the trade. Kingsley testified that the trades at issue would have been made in the absence of the soft dollar arrangements with FSS and would have been made at the same price and commission rate. He further testified that KJMM could not have used the commissions at issue here to obtain additional research, because it already had all the research it could productively use and had substantial amounts of additional commission available.[19] I credit

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[19] The record shows that KJMM paid total commissions of about $4.1 million in 1985, and that of this amount about $2.1 million was directed for research and economic services.

the Kingsley and Morse testimony on these points. In addition, the record shows that KJMM placed substantial business with Bear Stearns unrelated to the transactions at issue. The fact remains, however, that even if KJMM's interest in fulfilling its soft dollar obligations in fact had no effect on the transactions executed for clients, there existed a potential conflict of interest which needed to be disclosed.[20] In the Capital Gains Research case, the Court rejected the argument that the respondents' advice was given honestly and not for the purpose of furthering their personal pecuniary objectives, pointing out, among other things, that the Act was directed not only against dishonor, but also against conduct that tempted dishonor and that the Act, in recognition of the adviser's fiduciary relationship to his clients, required that his advice be disinterested. 375 U.S. at 200-01. The issue now to be considered is whether the soft dollar arrangements with FSS were adequately disclosed.[21]

Respondents concede that the FSS services and the related soft dollar arrangements were not specifically disclosed. They defend the absence of specific disclosure on the grounds that the disclosure that was made was comprehensive, and that those arrangements had not been shown to be material. The Division, on the other hand, takes the position that the disclosure was not adequate and that the arrangements and the nature of the services obtained were material.

Pickard, respondents' expert witness, testified that KJMM's disclosure in response to Item 11 of Part II of Form ADV was adequate and accurate and complied with the

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[20] Clearly, the conflict would have been greater had there been paying up. However, the fact that there was no paying up did not remove the conflict.

[21] The analysis is essentially the same whether the issue is disclosure of the conflict of interest or simply of the soft dollar arrangements as such.

Commission's disclosure requirements, and that "overall, the description of the portfolio transaction process were [sic] as comprehensive as any I have seen regarding investment advisory disclosure of brokerage execution practices." (Tr. 1-169). In explaining his conclusions, Pickard noted that the KJMM disclosure referred to the use of portfolio commissions not only for research, but also for "other services," and the fact that the research and other services were not only relevant directly to client portfolios but were also "expected to enhance the general portfolio management capabilities" of the firm.[22] He also cited the last paragraph of the disclosure, referring to "certain services," noting that this description was not confined to research. He opined that as he understood the services provided to KJMM by FSS, they fell within the disclosure. While I have great respect for Pickard's experience and judgment, I cannot agree with his conclusion that KJMM's disclosure complied with the requirements contained in Item 11. The instructions to Item 11, as previously noted, required that where the receipt of services other than brokerage or research services was a factor in the selection of brokers, "this description should specify them." (Resp. Ex. 68 (emphasis added)).[23] The general and broad disclosure that was

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[22] The Division asserts that the services provided by FSS to KJMM did not, and could not reasonably have been expected to, "enhance the general portfolio management capabilities" of KJMM. In view of my other findings regarding the inadequacy of KJMM's disclosure, it is unnecessary to rule on this contention.

[23] By contrast, where it was the receipt of research services that was such a factor, the instructions provided that "this description should identify the nature of such research services." Respondents note that details respecting the other $2 million (approximately) in directed commissions that KJMM had in 1985 were also not disclosed. The difference in terminology indicates that less specific disclosure was required for "research services" than for "other services." In any event, no issue has been raised regarding the adequacy of KJMM's disclosure concerning the receipt of research services.

made cannot by any means be considered a specification of the services received from FSS.[24] In its 1986 Interpretive Release on Section 28(e), the Commission, discussing the disclosure required in Form ADV regarding brokerage discretion, stated that the purpose of that disclosure is to provide clients with material information about the adviser's brokerage allocation policies and practices which may be important to them in deciding to hire an adviser or continue a contract with an adviser, and which will permit them to evaluate any conflicts of interest inherent in the adviser's arrangements for allocating brokerage. The Commission added that the disclosure made should provide sufficient information to enable a client or potential client to understand such policies and practices.[25] (Securities Exchange Act Release No. 23,170 (April 30, 1986), 35 SEC Docket 905, 909). While this pronouncement of the Commission postdated the events under consideration here, it did not represent a departure from earlier standards.

As noted, respondents further contend that the specific services provided and the soft

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[24] The Division asserted that KJMM made inadequate disclosure in the Form ADV filed in 1986, pointing to the requirement of the form, as revised in 1986, that under specified circumstances "any procedures the [adviser] used during the last fiscal year [in KJMM's case the calendar year] to direct client transactions to a particular broker in return for products and research services received" must be described. It is not at all clear, however, that this particular requirement called for description of the specific services received by KJMM in the prior year. In any event, for purposes of the alleged Section 206 violations, it is the disclosure in 1985, the year in which the soft dollars were paid and the services provided by FSS, that is relevant.

[25] The Commission, referring to the requirement in Item 12 of Part II of Form ADV that, under specified circumstances, an investment adviser must describe "products, research and services" received from broker-dealers, stated that an adviser need not list individually each product, item of research, or service received, but can state the types of products, research or services obtained with enough specificity so that clients can understand what is being obtained. 35 SEC Docket at 909, n.29.

dollar arrangements were not material and therefore were not required to be specifically disclosed. They point out that the amounts at issue represented less than 1% of total brokerage commissions paid by KJMM in 1985 and less than 1% of each client's commissions. They further assert that what was involved was an isolated occurrence and that there was no paying up. Respondents' position is supported by Pickard's testimony. Respondents also point to the materiality standard adopted by the Supreme Court in TSC Industries v. Northway, Inc., 426 U.S. 438 (1976) (proxy solicitation context) and Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (Section 10(b) of the Exchange Act and Rule 10b-5 context) to the effect that an omitted fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making decisions. They note that the Court in TSC Industries pointed out that too low a standard of materiality might bring an overabundance of information within its reach and lead management "simply to bury the shareholders in an avalanche of trivial information . . . ." (Id. at 448-49). Respondents contend that the Division's position would require disclosure of a mass of immaterial detail, obscuring the disclosure of material information as to factors the adviser used in selecting brokers. Noting that KJMM used over $2 million in directed commissions in 1985, respondents urge that if disclosure of each transaction were required, clients would be deluged with information of no conceivable benefit to them.

The Division maintains that dollar value is not an exclusive test for materiality and that in this case the soft dollar arrangements and the nature of the services obtained were material regardless of dollar value. In support of its argument it points to several theories of materiality which it urges are applicable here, among them that nondisclosure of a potential conflict of interest or nondisclosure of facts required to be disclosed in a Commission form such as Form ADV are nondisclosures of material fact. For the

proposition that nondisclosure of a potential conflict of interest is a nondisclosure of material fact, the Division relies on Steadman v. SEC, 603 F.2d 1126 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981), a decision on appeal from a Commission decision. The Commission had held that an investment manager's nondisclosure of his heavy borrowings from the same banks in which he caused the investment companies managed by him to deposit large sums in non-interest bearing accounts was a material nondisclosure in violation of antifraud provisions, including Sections 206(1) and (2) of the Advisers Act. (Steadman Security Corporation, et al., 46 S.E.C. 896 (1977)). The Commission said that the manager's collateral banking relationships were such that a reasonable investor could reasonably have drawn adverse inferences about the character of the funds' management and could reasonably have deemed the banking relationships "corrupting." It pointed out that the manager's conduct had a potential for subordinating the funds' interests to his need for bank loans, and, in terms of the TSC Industries standard, was of sufficient moment to create "a substantial likelihood that a reasonable shareholder would consider it important." (Id. at 907). While remanding on other grounds, the Court, referring to the Supreme Court's statement in TSC Industries that the determination of materiality was peculiarly within the competence of the trier of fact, affirmed the Commission's finding on that issue. Whether Steadman stands for the proposition, as stated by the Division, that disclosure of a "mere potential conflict of interest" is required or, as stated by respondents, that disclosure of a "material conflict of interest" is required, it supports a conclusion that KJMM was required to disclose the arrangements with FSS. Of course, the amounts involved in this case are far smaller. Yet there is, in my judgment, a substantial likelihood that a reasonable client or prospective client of KJMM would have considered it important in his dealings with the firm that it had placed, or was placing, itself in a position where it

needed to generate commissions in order to obtain services that were essentially for its benefit.

The Division also urges that where facts must be disclosed under a statute, or a Commission rule or form, such facts are by definition material, citing, among other cases, SEC v. Levy, 706 F. Supp. 61, 72 (D.D.C. 1989). There the Court held that the fact that certain information was required to be disclosed under Section 13(d) of the Securities Exchange Act was strong evidence that it was material under Section 10(b) of that Act. Recently, the Court of Appeals for the Second Circuit, in United States v. Bilzerian, 926 F.2d 1285, 1298 (1991), while declining to hold that information required to be disclosed in Schedule 13D was material per se for purposes of Section 10(b) simply because such disclosure was required under the securities laws, further held, citing Levy, that the fact that the information was required to be revealed under Section 13(d) was evidence of its materiality. It is clear that the Commission deems information which it specifically requires to be disclosed in various forms such as the Form ADV to be material. As noted, Item 11 (and subsequently Item 12) required a specification of services (other than brokerage or research services) that was not provided here.[26] While it is reasonable to import a de minimis exception into this requirement, the FSS services and related soft dollar arrangements do not in my judgment fall within it. It does not follow, as respondents contend, that to require disclosure of these unusual arrangements would require disclosure of a mass of immaterial detail or "an avalanche of trivial information" (quoting from TSC Industries). No one has suggested, as respondents imply would follow from requiring

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[26] Respondents argue that Item 11 required a discussion of factors in the selection of brokers, not of specific transactions. The argument, however, overlooks that portion of the instructions requiring specification of services.

disclosure here, that KJMM should have disclosed each transaction involving directed commissions or that its disclosure regarding the receipt of research as a factor in the selection of brokers or the determination of the reasonableness of commissions paid was inadequate. It is because the services received from FSS were of an unusual nature and were beneficial primarily to KJMM that disclosure was required. Finally, the fact that there was no paying up in the transactions through Bear Stearns for the credit of Goodrich does not lead to the conclusion that the FSS arrangements were not material. Underlying respondents' argument in this respect is the thought that since the commissions paid in those transactions were the lowest available commissions, services received in return for those commissions were in effect free. As Pickard put it, "[t]here was no incremental increase or burden upon the account[s] by virtue of this service being provided." (Tr. 1-167). The fact remains that clients needed the information in order to evaluate the potential conflicts of interest inherent in the FSS arrangements.

Respondents further contend that the Division has failed to show any harm or injury to KJMM's clients as a result of the challenged conduct, and that therefore no violation of Section 206 can be found. In large part, this argument is predicated on the contention that there was no paying up in the transactions under consideration. The argument lacks merit, because it is well established that in enforcement actions by the Commission, as distinguished from private actions, no showing of harm or injury is required. For example, in SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985), the court said that violations of the antifraud provisions of Section 206 do not depend on actual injury to a client. (See also, e.g., Berko v. SEC, 316 F.2d 137, 143 (2d Cir. 1963); Shaw, Hooker and Co., 46 S.E.C.

1361, 1366 (1977)).[27]

Equally without merit is respondents' further argument that KJMM's clients had consented to the use of commissions involved here. The argument rests on the fact that those clients had received Part II of KJMM's Form ADV before the transactions at issue and had signed receipts for them, and that, with a few exceptions, they had signed form advisory contracts which according to respondents expressly permitted this use of directed commissions. However, I have already found that the disclosure in the Form ADV was insufficient. No client could have divined the kinds of services that KJMM received from FSS. The advisory contracts were no more specific.

Based on the above findings, I conclude that KJMM willfully violated Sections 206(2) and 204 of the Advisers Act and Rules 204-1 and 204-3 thereunder and that both KJMM and Kingsley willfully violated Section 207 of that Act. None of these provisions has a scienter element. On the question of willfulness, respondents assert that they acted in the good faith belief that their conduct was lawful. However, the willfulness standard they would have me apply has been pronounced in other contexts. The Commission, with judicial support, has consistently held that a finding of willfulness does not require a specific intention to violate the law or an awareness that the law is being violated, and that it is enough that the respondent intentionally committed the act that constitutes the violation

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[27] In Capital Gains Research, the Supreme Court stated that with respect to injunctive actions under Section 206(2) of the Advisers Act, Congress did not intend to require proof of intent to injure and actual injury to the client. 375 U.S. at 192. While the Court, in a footnote (n.40), distinguished administrative as well as criminal proceedings, stating that other considerations may be relevant in such proceedings, this cryptic statement has not in later judicial and administrative decisions been viewed as establishing a different standard for administrative proceedings.

or, if charged with a duty to act, failed to meet his responsibility.[28]

In order to find a violation by KJMM of Section 206(1) of the Advisers Act, there must be a finding of scienter. The Commission has consistently held that recklessness satisfies the scienter requirement.[29] With reference to the allegation that Kingsley willfully aided and abetted KJMM's violations, the applicable standards were set forth in William R. Carter, et al., 47 S.E.C. 471, 502-03 (1981), where the Commission held that, in the context of the federal securities laws, three elements must be present for aiding and abetting: (1) an independent securities law violation that has been committed by some other party; (2) the aider and abetter "knowingly and substantially assisted" the conduct that constitutes the violation; and (3) the aider and abetter "was aware or knew that his role was part of an activity that was improper or illegal." The Commission further recognized that the awareness or scienter requirement incorporated in the third element could be satisfied not only by knowledge, awareness or intent, but also by recklessness. (Id. at 504).[30] There is no question here regarding the presence of the first two elements.

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[28] See, e.g., Roman S. Gorski, 43 S.E.C. 618, 621 (1967); Frank W. Humpherys, 48 S.E.C. 161, 164 (1985); Tager v. S.E.C., 344 F.2d 5, 8 (2d Cir. 1965).

[29] See, e.g., Michael Joseph Boylan, et al., 47 S.E.C. 680, 687, notes 24 and 25 ("knowing conduct" or recklessness satisfies the scienter requirement); Richard W. Suter, 47 S.E.C. 951, 957, n.6 (1983), aff'd in unpublished opinion, (7th Cir., 7/2/85). See also Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir. 1978), cert. denied, 439 U.S. 1039 (where alleged aider and abetter owes a fiduciary duty to the defrauded party, recklessness satisfies the scienter requirement).

[30] In an initial decision I issued in 1984, I suggested that in a context where (1) the primary violation does not require a finding of scienter; (2) the statutory provision in issue can be violated only by a broker-dealer (or, as in this case, an investment adviser); and (3) a principal charged with aiding and abetting the violation is directly responsible for the firm's

In contending that the record shows that the requisite scienter was present, the Division asserts that KJMM, through Kingsley, knew what services were being provided by FSS and that those services and the soft dollar payments for them were not being disclosed in KJMM's Form ADV. It also notes that Kingsley reviewed the Forms ADV before they were filed with the Commission. The Division asserts that the above conduct far exceeded the recklessness required to establish scienter. Respondents, on the other hand, urge that the Division's evidence falls far short of any showing of intentional conduct or recklessness. On the contrary, they urge, KJMM's principals acted in good faith, believing that the transactions at issue would provide substantial benefits to their clients and that the conduct was appropriate and lawful in the absence of paying up. Among other things, they state that the principals made a substantial effort to inform themselves of the law, were assured by Blair that his counsel had cleared the use of directed commissions, and reasonably concluded that the disclosure in KJMM's Form ADV was adequate.

While the issue is a close one, I have concluded that in failing to disclose the soft dollar arrangements with FSS, KJMM and Kingsley acted recklessly. Kingsley testified that based on his long experience in the investment management industry, his reading of pertinent literature and his attendance at seminars, it was his understanding that any

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misconduct, no finding of scienter or awareness of wrongdoing by the principal should be necessary in order to find aiding and abetting. Annette Langheinrich, November 21, 1984, Adm. Proc. File No. 3-6321, Notice of Finality, Securities Exchange Act Release No. 21,595 (December 21, 1984), 32 SEC Docket 163. My reasoning was that the rationale for requiring scienter or awareness of wrongdoing in order to find aiding and abetting was to protect persons having only a secondary role in the alleged misconduct, and that this rationale was not applicable in the situation posited. The Commission has not adopted the suggested approach. I respectfully suggest that it may warrant further consideration.

concern regarding the use of soft dollars was focussed on paying up, and that in the absence of paying up there was no problem. He further testified that he relied on Blair's assurance that FSS's counsel had cleared the use of soft dollars for the services provided by FSS. However, as noted, the Commission had stated in its 1976 Release that services which were readily and customarily available and offered to the general public on a commercial basis were not protected by the safe harbor. This was pointed out in an outline which Kingsley received at an Investment Company Institute seminar in 1984 and which he introduced as an exhibit. (Resp. Ex. 21(a)). This outline also stated that the receipt of other than research or brokerage services was prohibited.[31] Kingsley was clearly aware that the use of soft dollars in this instance was of an unusual nature. This is borne out by the fact that he raised the subject with Blair before engaging him to perform the services. Instead of consulting counsel of his own or seeking advice or a no-action position from the Commission's staff, he accepted Blair's representation that the latter's counsel had approved the use of soft dollars for FSS's services. Kingsley must have realized that FSS and Blair had an interest in convincing potential users of their services that such services could be purchased with soft dollars and that he could not view the advice of their counsel as disinterested with respect to him and KJMM. I regard as particularly significant the fact that, with knowledge of the unusual nature of the services, Kingsley saw fit to make no change in Item 11 of KJMM's Form ADV which had been unchanged for several years, without seeking legal advice on the matter.

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[31] A second document received by Kingsley at the seminar, apparently produced by the ICI, included the statement, purportedly taken from the Commission's Investment Adviser Examination Manual, that a breach of an adviser's fiduciary obligations constitutes a violation of the antifraud provisions of the Advisers Act.

Accordingly, I further find that KJMM, willfully aided and abetted by Kingsley, willfully violated Section 206(1) of the Advisers Act and that Kingsley willfully aided and abetted the violations by KJMM of Section 204 and Rules 204-1 and 204-3 thereunder.

IV. PROCEDURAL ISSUES

Estoppel

Respondents contend that the Division is estopped from pursuing these proceedings because they relied on (1) the Commission's regulations, interpretations and instructions in effect in 1985, and (2) a 1980 letter from the Commission's staff following an examination of KJMM's books and records, which called for certain corrective action but said nothing about the brokerage allocation disclosure in KJMM's Form ADV.

In ruling on the Division's prehearing motion to strike respondents' affirmative defenses, including estoppel, I declined to strike the estoppel defense because the Supreme Court had declined to lay down a flat rule that estoppel can never run against the government. (Heckler v. Community Health Services, 467 U.S. 51, 60 (1984)). In that decision, the Court had further stated, however, that one asserting an estoppel against the government bore a heavy burden, heavier than that assumed where the defense was invoked against a private litigant. Basic elements of any estoppel are misrepresentations of fact and reasonable reliance thereon by the party claiming the estoppel. Here, respondents' estoppel claim rests on the argument that in 1985 there was confusion as to the directed commission practices that the Commission viewed as falling within the safe harbor of Section 28(e). Assuming the accuracy of the argument in relation to the services in question here,[32] it

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[32] The Division urges that because of no-action letters dealing with the issue of whether certain promotional materials must be paid for in hard dollars, there was no confusion in 1985 as to whether it was appropriate to use soft dollars to pay for

provides no support for the estoppel contention but rather leads to the conclusion that respondents should not have proceeded without seeking the advice of counsel. Likewise without merit is respondents' argument that in completing KJMM's Forms ADV, they relied on and complied with the instructions in the Form. The fact is, as found above, that those instructions called for specificity in the description of services other than brokerage or research services.

I also find no merit in respondents' argument based on the 1980 staff examination and the fact that the brokerage allocation disclosure which the staff did not criticize continued unchanged through 1985. The simple answer to the argument is that the services at issue were not performed until 1985, so that the question of appropriate disclosure regarding those services did not exist in 1980.

Right to Counsel

In 1987, Kingsley and Jonckheer were asked to appear voluntarily before a Commission staff member to testify. They testified without counsel. Respondents now claim that because Kingsley and Jonckheer were not notified that they (and KJMM) were "targets" of the investigation, taking their testimony for later use against them was a denial of their right to counsel and a violation of due process of law. As part of the argument, respondents assert that Kingsley and Jonckheer were not aware that they were at risk and in fact were misled as to the target of the investigation, and that they therefore could not make an intelligent and voluntary waiver of their right to counsel. The record shows that at the outset of their testimony Kingsley and Jonckheer were notified both orally and in writing of their right to be accompanied, represented and advised by counsel of their choice.

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services designed to assist an investment adviser with marketing itself.

Each of them stated that he understood that he had that right as well as the right to have the testimony adjourned at any time to enable him to obtain counsel. The form that each of them received prior to testifying also advised that he could invoke the Fifth Amendment privilege against self-incrimination and that, "if your testimony is not pursuant to subpoena, your appearance to testify is voluntary, you need not answer any question, and you may leave whenever you wish. Your cooperation is, however, appreciated." (Div. Ex. 93.1). Kingsley and Jonckheer elected to give their testimony without counsel.

The Division does not deny that KJMM and Kingsley were "targets" of the investigation at the time Kingsley and Jonckheer gave their investigative testimony, and for the sake of discussion I assume that they had that status.[33] Nevertheless, respondents' arguments fail both on factual and legal grounds. At the outset of Jonckheer's testimony and in the same way at the outset of Kingsley's testimony, the staff attorney taking the testimony stated that the witness's testimony had been requested by the staff as part of an informal inquiry "in the matter of Financial Selected Services" to determine whether there had been violations of certain provisions of the federal securities laws. Respondents assert that Kingsley and KJMM were led to believe that the staff was only conducting an investigation of FSS and Blair, and that it was only months later, when the Division advised them that it was recommending the institution of administrative proceedings, that they became aware that they were at risk. While the language of the staff attorney at the outset of the investigative testimony, taken by itself, could be subject to the interpretation

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[33] Respondents, drawing on a definition in the United States Attorneys' Manual, define a "target" as a person as to whom the investigator has substantial evidence linking him to a violation and who, in the judgment of the investigator, is a "putative respondent." The term is not defined in the securities laws or the Commission's regulations.

suggested by respondents, the record shows that respondents were put on notice some weeks earlier that they were "at risk." The instrument for doing this was a letter to Morse, as KJMM's president, from the attorney who later took the investigative testimony. In the letter, she stated that the Commission's Los Angeles Regional Office was conducting a preliminary inquiry into certain commission payments for services provided by FSS, and that the purpose of the letter was to bring to KJMM's attention certain requirements of the federal securities laws and to request specified information relating to payments to FSS. The letter referred to antifraud provisions, paraphrasing Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; paraphrased Section 28(e) of the Exchange Act; and added that "[m]oreover, as an investment adviser which is or was registered under the Investment Advisers Act of 1940 your firm is also subject to the provisions of that act" (Resp. Ex. 12). The letter went on to request that specified documents be provided and that the writer be contacted to schedule a date for testimony. Among the documents requested, in addition to documents relating to services provided to KJMM by FSS and Blair and commissions directed for the benefit of FSS and/or Blair, were copies of brochures or other writings provided to KJMM's clients disclosing its brokerage allocation policies and, for the years 1983-1986, documents relating to services provided to KJMM that were paid with directed commissions. The response to the letter was signed by Kingsley. The letter left no doubt that the staff inquiry was not limited to the conduct of FSS, and that KJMM's conduct was also a subject. Under the circumstances, I reject the argument that Kingsley and Jonckheer were not aware at the time of their testimony that at least KJMM was a potential

respondent or that they were misled by the staff attorney's statements.[34]

Moreover, respondents' legal arguments are unsupported. They cite constitutional, statutory and Commission rule provisions for the proposition that persons in the position of Kingsley and Jonckheer had a right to counsel. No one disputes that proposition; the two men were in fact given the right to have counsel. Respondents cite no authority for the proposition that the staff was under an obligation to notify the witnesses that respondents were targets of the investigation,[35] or that the failure to do so somehow violated their right to counsel. And, particularly in light of my findings regarding respondents' awareness that they were subjects of the investigation, their contention that Kingsley and Jonckheer could not validly waive their right to counsel because they did not

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[34] Jonckheer's investigative testimony is also illuminating. The following segment of his testimony relates to a discussion between him and Kingsley after the staff letter arrived:

> Q. Well, what exactly did he say to you?
> A. I don't know what exactly he said, but it was words to the effect that we were being audited by the SEC because of our, whatever, what's the right verb?
> Q. Or you received a letter, request letter.
> A. By the SEC requesting information on the, on our relationship with Jim Blair. And, again, he at that point mentioned in one phrase that that (sic) we had, you know, paid or compensated Jim through soft dollar, a soft dollar arrangement because that's what he, Rich, at that point understood was an appropriate method of compensation. So let's not get too worried and hysterical, but, you know, but provide the information. Now get me your files. It was something like that. . . .

(Div. Ex. 93 at 106-07).

[35] The Division cites the Supreme Court's decision in SEC v. Jerry T. O'Brien, Inc., 467 U.S. 735 (1984) for the proposition that the Commission is not required to advise a "target" of that status. The issue in that case, however, was whether the Commission had a duty to notify a target of an investigation when it issued subpoenas to third parties. I do not consider that the decision bears on the issue raised here.

know that they were at risk is also without merit. The record simply does not support their argument that the waiver was not made on a knowing, intelligent and voluntary basis.[36]

Delay in Institution of Proceedings

These proceedings were instituted in January 1991. The violations took place in 1985. Respondents contend they were prejudiced by the delay in the institution of proceedings, in that the intervening deaths of Blair, his associate in FSS and the attorney for FSS and Goodrich Securities deprived respondents of the opportunity to take their testimony. Respondents point to two specific parts of the record. One is a series of audio tape recordings and transcriptions thereof that I admitted, over respondents' objections on authenticity grounds, as recordings of the December 1985 seminar. The second consists of various brochures, letters and other documents emanating from Blair or FSS, characterized by respondents as hearsay, which they claim provide a foundation for much of the Division's case. Respondents further claim that as a result of the delay, witnesses' memories had faded.

In my judgment, the delay, though unfortunate and undesirable, has not prejudiced respondents' legal rights. While it is true that the witnesses, in particular Jonckheer and Kingsley, no longer had a clear recollection of some of the details of the events that took place in 1985, they recalled the main aspects of those events with sufficient clarity to give me confidence that findings based on their testimony (including, of course, their 1987

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[36] Respondents' suggestion, at page 58 of their brief, that prior consultation with counsel is a prerequisite to a valid waiver of counsel is not supported by the cases they cite. Their principal authority, Connecticut v. Townsend, 558 A.2d 669, 673 (Conn. 1989), held merely that in determining a defendant's capacity to make an intelligent waiver of his right to counsel, one of many relevant factors to be considered by the court is consultation with counsel prior to proceeding pro se.

investigative testimony) are accurate. As far as the tape recordings are concerned, I have not relied on them in making findings herein. To the extent I have relied on letters and other documents emanating from Blair and FSS, I have done so only where I found them to be trustworthy or corroborated by testimony herein.

V. PUBLIC INTEREST

The remaining issue concerns the remedial sanctions, if any, to be imposed on respondents in consequence of the violations found. The Division suggests as appropriate sanctions a censure of KJMM and a 12-month suspension of Kingsley from association with an investment adviser. Respondents urge that no sanction is warranted.

In support of its position, the Division urges that the violations committed by respondents were egregious, involving breaches of fiduciary duty, and recurred over the course of a whole year. It further notes that respondents have given no assurance against future violations and do not yet recognize that their conduct was wrongful. It also points to the importance of deterring similar misconduct by others. Respondents, on the other hand, stress that neither Kingsley nor Morse, in their many years in the investment industry, nor KJMM has ever been subject to any other proceeding, complaint or suit, either before the events at issue here or since. They point to the relatively small amount of commissions involved in the FSS matter, and they assert that it involved an isolated occurrence and that they believed they were acting lawfully and for the benefit of their clients. Respondents also note that KJMM now has securities counsel with which it consults regularly on compliance issues. Finally, they point out that Kingsley is suffering from a progressive terminal disease, with a prognosis of survival at best for a few more years.

The proposed censure of KJMM seems clearly appropriate. However, the suspension that the Division would have me impose on Kingsley is excessive. Of course, I do not

justify the violations, which were serious. It does appear, however, that, as Pickard testified, there was uncertainty in 1985 as to the law in the soft dollar area, and it is my conclusion, based on Kingsley's testimony and his demeanor, that he believed KJMM was within the law in the arrangements at issue and their disclosure and that the services received from FSS benefited KJMM's clients. The fact that there was no paying up in the transactions in which the soft dollars were generated is also a mitigating factor. Considering in addition, among other factors, Kingsley's otherwise unblemished record over a period of more than thirty years and his illness which has already taken a substantial toll, I conclude that as to him as well a sanction of censure is appropriate in the public interest.[37]

VI. ORDER

Accordingly, IT IS ORDERED that Kingsley, Jennison, McNulty & Morse, Inc. and Richard Kingsley are hereby censured.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice. Pursuant to that rule, this initial decision shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 17(b) within 15 days after service of the initial decision upon him, unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him. If a party timely files a petition for

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[37] All proposed findings and conclusions and all contentions have been considered. They are accepted to the extent they are consistent with this decision.

review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.

Max O. Regensteiner
Administrative Law Judge

Washington, DC
November 14, 1991