



**CONFLICT OF INTEREST PROBLEMS IN THE SECURITIES INDUSTRY**

**Address by**

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## CONFLICT OF INTEREST PROBLEMS IN THE SECURITIES INDUSTRY

I wish to speak today about the problem of possible conflicts of interest in the securities industry. It might be best if I started our discussion with those conflicts which relate to or, hopefully, are minimized by the first and most basic type of our federal securities laws; namely, the disclosure provisions. These were first enacted in the Securities Act of 1933 and then augmented soon thereafter by the Securities Exchange Act of 1934. The Commission's primary concern in enforcing these particular statutory provisions is to place prospective investors in a position to make informed evaluations and judgments as to the merits of individual securities. As you know, we are not, in many cases, empowered to actually prohibit conflicts of interest which we discover.

Specific item requirements contained in the registration forms filed under the 1933 Act and in the periodic reports filed pursuant to the 1934 Act call for disclosure of any material interest, direct or indirect, of certain insiders in any material transactions to which the registrant or any of its subsidiaries was a party during a specified number of years preceding the date of the filing in question. In order to comply fully with these items, the registrant identifies the person or persons involved, the nature of their relationship to the company, the nature of their interest in the transaction and the amount of such interest. If the transaction involves assets purchased by the registrant or any subsidiary, otherwise than in the ordinary course of business, the cost of such assets to the purchaser and the cost thereof to the seller is required to be disclosed if the assets were acquired by the seller within two years prior to the transaction. Information is also to be included as to any material underwriting discounts and commissions received upon the sale of securities by the registrant where any of the specified insiders was a principal underwriter or a controlling person or member of a firm which was a principal underwriter. Finally, these items also require appropriate disclosure of any proposed transactions which are material that involve certain insiders to which the registrant or any of its subsidiaries is to be a party. In reviewing these transactions, the Commission's staff will frequently request that the registrant characterize the amounts charged or paid as "competitive" or "non-competitive" in relation to what would have been the consideration paid by or charged to an unaffiliated person. So-called "blank check" or "blind pool" offerings present conflict of interest problems where a material portion of the proceeds of the relevant offering is to be applied to purposes to be determined by management at some future time. This approach obviously exposes prospective investors to a variety of additional risks. The disclosure sought by the staff in these instances is designed to warn the investor that the expenditure of funds may involve transactions with insiders. In addition, the management should be pinned down as to the extent to which "inside" transactions may occur and as to the general form they may take.

One major area of concern for the Commission involving disclosure about conflicts of interest is most often apparent where the registrant is a limited partnership or a trust whose general partner or managing trustee is currently involved in a number of different activities, some of which may be in direct competition with the business of the issuer. Specific examples of offerings involving such conflicts can be found in prospectuses relating to the sale of partnership, limited partnership, or joint venture interests in oil and gas ventures and shares of beneficial interest in real estate investment trusts.

Turning initially to oil and gas offerings, the general partner or agent of a venture, or their affiliates, may maintain an inventory of oil and gas leases, a portion of which it may decide to sell to the venture in preference to having it acquire similar leases from unaffiliated persons or may control a drilling contractor or supply firm which is to sell or lease equipment to the venture. It should be noted that this related business interest of the general partner or agent may not always be detrimental to the venture's overall interest in that, because of the fact of his other, previous oil and gas interests, he will in many cases be able to bring more experience to its management, thereby being of benefit. The practice is, however, vulnerable to abuse and, thus, merits disclosure. In an attempt to minimize the potential for abuse in connection with this "two hat," or self-dealing, type of conflict, the general partner or agent will often pledge to sell oil and gas leases which he owns to the venture at a price equal to his acquisition cost of such properties and provide that the terms of equipment rental leases, or agreements to drill wells or perform other services for the venture, will be at least as competitive as those then generally prevailing in the industry.

In some instances, such general partners or agents may also have equity interests of varying sizes in other oil and gas programs. In deciding which program should acquire and develop a particular leasehold, a conflict can easily arise. Our staff, in situations such as this, requests that the venture's prospectus set out in as much detail as possible the criteria its general partner or agent will follow in determining where particular leases will be placed. Comparable disclosure is required in connection with the practice of transferring leases from one program to another and situations where the general partner or agent may himself provide the financing for the venture or, conversely, invest venture funds in lease acquisitions and drilling adjacent to other leases in which he has an interest.

In order to deal more comprehensively with these and other conflicts in the oil and gas industry, the Commission, at the direction of Congress and in cooperation with representatives of the industry, is now working out a regulatory statute to propose to Congress by June of 1972. This law presumably will be a regulatory statute analogous to the Investment Company Act of 1940 and, like that Act, will operate in tandem with our other, disclosure oriented, statutory provisions.

We find similar problems in the area of real estate investment trusts. These trusts are established to invest in a variety of different real estate oriented areas, including first mortgage construction and development loans, equity interests or interests in the borrowers whom the trusts finance. In many instances, the trusts are organized and managed by banks or other financial or investment entities whose activities include construction and development, mortgage origination and servicing and investment in real estate. Potential conflicts of interest arise here analogous to those I described in the oil and gas industry and include difficulties inherent in deciding which investment opportunities are to be passed on to the trust and which are to be acquired and retained for management's business purposes outside of the trust and in the possibility of sale by the managers, trustees or their affiliates of particular assets from their own portfolios to the trust.

One of the staff's primary concerns in the real estate investment trust area is the clarification of any limitations which the general managers will place on their potentially vulnerable powers. One safeguard that is commonly utilized for this purpose is a requirement that the majority of the trustees be unaffiliated with the managers or advisers of the trust. These unaffiliated trustees can then be required to approve any investments made by the trust involving the manager or its affiliates and to review the manager's records to determine whether it is making a proportionate number of quality loans and investments available to the trust. Other possible safeguards include a right of the trust to first refusal of certain types of loans originated by the manager and an express ceiling on the aggregate amount of loans which can be made by the trust in connection with investments controlled by the manager or its affiliates.

I would now like to move on to a discussion of conflicts within the brokerage-advisory segment of the securities business. William McChesney Martin, former Chairman of the Federal Reserve Board and former President of the New York Stock Exchange, in a recent report submitted to the Board of Governors of the Exchange on August 5, 1971, expressed the view that unavoidable conflicts are created by the industry's practice of combining in one firm the disparate functions of money management and brokerage services. He indicated that such conflicts are not resolved even where the brokerage firms render their advisory services without additional compensation beyond the brokerage firm's usual fees. The most obvious of these conflicts is the temptation to churn customers' accounts to generate additional commissions. Notwithstanding an almost universal recognition of the existence of this particular temptation, broker-dealers have been permitted for years to manage accounts on a discretionary basis, buying and selling securities for their clients without the necessity of obtaining their prior approval. This dual role of the broker and money manager can lead to still a further conflict where the broker is concurrently trading for his own account as a dealer and is faced with a choice of whether he or his client should be the first to benefit from the broker's decision as to the desirability, or lack thereof,

of a particular security. Related problems include a broker-dealer who is participating in a public offering unloading his participation on his discretionary accounts or purchasing securities at a relatively low price and thereafter recommending them and selling them to customers on the resulting price rise.

The anti-fraud provisions of the federal securities laws generally serve as a prophylactic measure with regard to such practices before they occur and as a punitive measure thereafter. Additionally, Rules 15c1-6 and 15c1-7 under the Securities Exchange Act of 1934 serve a disclosure function in this same area. Rule 15c1-6 requires the broker-dealer who is participating or is otherwise financially interested in the distribution of a security to disclose, in writing, such participation or interest to any customer for whom he effects a transaction in that security. Rule 15c1-7, which prohibits a broker or dealer from effecting any transactions in discretionary accounts which are excessive in view of the character of the account, also requires that a broker or dealer make a record of each transaction in his discretionary accounts, including the name of the customer and the name, amount and price of the security and the date and time when the transaction took place.

Although the inherent conflicts between brokerage business and management have been discussed for years, no serious suggestion has been made until recently to actually separate the two activities or truly insulate them from one another.

Mr. Martin emphasized the necessity for recognizing and preserving the difference between the securities business and other businesses. Although this particular comment was made with regard to the issue of institutional membership on the New York Stock Exchange, one might consider applying the same principle to broker-dealers. In this vein, Mr. Martin recommended that Exchange member firms be required to divest themselves, over a reasonable period of time and in a manner which will protect the interests of the shareholders, of their interests in management or advisory companies of investment companies. In addition, he recommended that any investment advisory contracts between member firms and such advisory companies or their members also be prohibited in order to avoid the use of such contracts to effect indirect control of such companies and that broker-dealers be prohibited from crediting commissions against any fee charged for investment advice. He did go on to state, however, that member firms should be permitted to engage in all other forms of money management. Although I do not wish to comment favorably or unfavorably upon Mr. Martin's recommendations at this point in time, certainly his comments are worthy of note and will be given a thorough analysis.

In recent months, the traditional combination of broker and dealer functions in our securities markets and the possible conflict of interest which this combination creates have been the subject of special attention. I refer to the retail firm that also "makes" a wholesale market over-the-counter in the same securities it sells to its customers. Here, the conflict of interest includes, but in some respects goes beyond, the more common one

of an agent who sells merchandise he himself owns to customers. In this situation, the broker not only may have the motive to make a profit on the merchandise he sells to his customer; he may also be motivated by the conflicting obligations that market makers almost necessarily assume. For example, to protect his position as a market maker, a broker must often buy from and sell to other professionals when his expert opinion dictates that he should be doing otherwise if he is to profit as a dealer on those particular purchases and sales.

In the recent case of Chasins v. Smith, Barney, 1/ which spotlighted the above described conflict, the Court of Appeals for the Second Circuit held, after withdrawing an initial opinion, that a customer who relies on his broker's objective appraisal of his needs should be told that his broker may, because of his concurrent wholesale obligations to other dealers, have conflicting, adverse interests of a material nature. In this particular case, the facts indicated rather clearly that the customer and the firm had a close investment advisory relationship and that the recommendation had resulted from a written portfolio analysis made in strong and seemingly objective terms.

In a subsequent decision rendered by a Federal District Court in Maryland, Batchelor, et al. v. Legg & Co., 2/ involving a somewhat different factual situation, the Court ruled that, in the absence of a showing of a special relationship between the plaintiff and his defendant broker, the failure to disclose market making activities was not a violation of the federal anti-fraud provisions.

The staff of the Commission currently is giving consideration to the drafting of rules which will further clarify the disclosure requirements with respect to this matter.

Another subject of special concern for the Commission in this general area is the underwriting or participation by broker-dealers in the distribution of their own securities or those of their affiliates. Any underwriter has distinct obligations to both the issuer and the ultimate purchasers of the security. Since he provides the means of furnishing the issuer with needed capital, he has an interest in setting terms that will provide funds sufficient to accomplish the issuer's objectives in making the offering. On the other hand, he must serve the public interest by bringing to the market a security that is reasonably valued, an appropriate type of financing, not overly diluted and otherwise suitable for investors. By his participation in these determinations, the underwriter often provides a significant degree of protection to the public investor because of the

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1/ Chasins v. Smith, Barney (483 F. 2d 1167 [2nd. cir. 1971]).

2/ Batchelor, et al. v. Legg & Co., CCH Fed. Sec. L. Rep. ¶93,120 (DC Md. 1971):

traditional value of his arm's-length relationship with the issuer. Where the issuer is himself the underwriter, there is no such arm's-length relationship between the two entities, and important investor protections may be weakened significantly.

The usual independence of the underwriter from the issuer also has a bearing on what provisions are made for underwriting compensation. Although the National Association of Securities Dealers and the Commission, acting for its SECO broker-dealers, have developed guidelines with respect to maximum permissible limits of underwriting compensation, just what compensation is received within those limits is a matter of negotiation between issuer and underwriter and may to a significant extent be dependent on the degree of their independence from one another.

It was these conflicts that led the NASD and the Commission, in the administration of its regulatory program for non-NASD broker-dealers, to impose in late 1969 tight restrictions on broker-dealers underwriting their own securities or those of their affiliates. After a year and a half of experience with this policy and in view of the need to improve the capital foundation of the brokerage industry, the NASD concluded, however, that some relaxation was needed so as to permit broker-dealers to obtain public financing for their operations. Accordingly, proposals are being considered by both the NASD and the Commission which will authorize such distributions under certain circumstances but, it is hoped, will minimize the dangers inherent in such sales.

I would like to now move into the last general area of discussion today; namely, conflicts of interest associated with investment companies. Quite a few of these conflicts are related to the investment company industry's strong ties with the brokerage business; but fortunately, where investment companies are involved, we have resort to the strong regulatory protections against such conflicts offered by the Investment Company Act of 1940. The practices of investment company management involving reciprocal arrangements in connection with brokerage generated by an investment company's portfolio transactions are probably the major examples of this type of conflict of interest problem. Brokers who effectuate these transactions on behalf of a fund are acting as agent for the fund. Section 17 of the Investment Company Act is directly in point here, although Sections 15 and 36 of the Act also come into play.

It is now generally recognized that implied in Section 15 is the idea that directors of investment companies will continuously and actively fulfill their fiduciary responsibilities to the investment company. <sup>3/</sup> This is buttressed by new Section 36(a) which I will describe in greater detail a little further on. But, again, in the particular conflict of interest area I am referring to, the most directly relevant section is Section 17(e). That section provides that persons falling under the definition of "affiliate"

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<sup>3/</sup> See Brown v. Bullock, 294 F. 2d 415 (C.A. 2, 1961); Rosenfeld v. Black, C.A. 2, No. 35820 (June 22, 1971).

acting as agents may not receive any compensation in such transactions other than regular salary from the investment company, except in the course of their business as a broker or underwriter. The Commission's decisions in this area, such as the Provident case, <sup>4/</sup> have indicated that receipt of such brokerage commissions under the statute is only to be permitted where the affiliate performs some actual brokerage service.

One potential means for institutional management which is engaging both in such management and in brokerage functions to use their "two hatted" role to assist their funds is to join an exchange, either directly or through a broker-dealer subsidiary, and thereby lower brokerage commission costs. The recent decision of the Court of Appeals for the First Circuit in Moses v. Burgin <sup>5/</sup> indicated that affiliated persons of a fund have no duty to create an affiliated broker to execute fund portfolio transactions on one or more national securities exchanges or to recapture brokerage if there are sound business reasons for declining to do so. The Court found, however, on the facts of that case, that the affiliated directors of the fund and its investment adviser were guilty of gross misconduct within the meaning of Section 36 of the Investment Company Act (prior to its recent amendment) when they directed give-ups arising from brokerage commissions generated by fund portfolio transactions to brokers selling fund shares instead of recapturing those commissions for the benefit of the fund and its shareholders. The specific breach of trust found was that the unaffiliated directors had not been informed of possible means of recapture that might have been available through a broker-dealer subsidiary of the adviser.

One further point should be mentioned here with respect to brokerage commissions and compensation levels paid to investment advisers. Section 36(b) of the Investment Company Act, which becomes effective on June 14, 1972, specifies that an investment adviser to a registered investment company has a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by a registered investment company or its shareholders to the adviser or any affiliated person of the adviser. One provision of new Section 36(b) states that the new section does not apply to compensation or payments made in connection with transactions subject to Section 17 of the Act. This provision has been construed by some to mean that brokerage commissions paid to an affiliate will not be taken into account in determining whether or not the level of compensation meets the standard required in new Section 36(b). Let me assure you that this is not the case. The

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<sup>4/</sup> In the Matter of Provident Management Corporation, et al., Securities Act Release No. 5115 (December 1, 1970). See also In the Matter of First Multifund of America, Inc., et al., Investment Company Act Release No. 6700 (August 26, 1971). |

<sup>5/</sup> Moses v. Burgin, et al., C.A. 1, No. 7745 (June 4, 1971), CCH Fed. Sec. L. Rep. ¶92,061; see also Gross, et al. v. Moses, et al., 67 Civ. 4186 (S.D. N.Y. 1971); Edelman, et al. v. Brown, et al., 71 Civ. 2162 (S.D. N.Y. 1971).



exception for Section 17 transactions does prevent a court, in an action brought solely under Section 36(b), from prohibiting an affiliated broker-dealer from receiving brokerage commissions on the fund's portfolio transactions or from reducing the amount of brokerage commissions received, since these are matters subject to Section 17(e) of the Act. The legislative history is abundantly clear, however, that in an action under Section 36(b) to determine whether overall compensation is excessive, the court may take into consideration all compensation and payments, including brokerage, accruing to an adviser and its affiliate as a result of the adviser's relationship with the registered company it manages.

One other area regarding the relationship between an investment company and its adviser which has been of recent concern involves the assignment of advisory contracts from one investment adviser to another and the question of whether any part of the consideration paid in such transactions should be passed on to the investment company.

The Second Circuit recently held in Rosenfeld v. Black 6/ that an investment adviser is a fiduciary and held, on this basis, that it, the adviser, comes within the scope of the principle that a fiduciary may not sell or transfer his office for personal gain. The Court went on to repudiate an earlier contrary opinion, the ISI case, 7/ by stating, in effect, that when Congress required shareholder approval of any new advisory contract in Section 15(a) it must have meant an approval uninfluenced by any improper motivations on the part of the outgoing adviser fiduciary. The very fact of nonassignability of an investment advisory contract demonstrates that any payment made to the outgoing adviser by his successor in these circumstances in excess of the value of any continuing services represents unlawful consideration for the use of influence in securing shareholder approval of the successor who expects to profit from the post.

A most important step against conflict of interest abuses in the investment company area was taken recently with the enactment of new Section 36(a) of the Investment Company Act in the 1970 Amendments. The new section authorizes the Commission to seek injunctive relief if affiliated persons violate prevailing standards of fiduciary duty involving personal misconduct in their actions taken with respect to these companies. Thus, the more restrictive standard previously applied requiring gross misconduct or gross abuse of trust has been abandoned.

Another problem area involving Section 36 breach of fiduciary duty standards, one which is of particular interest to you gentlemen, I am sure, relates to actions by boards of directors of investment companies unilaterally

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6/ supra, note 3.

7/ SEC v. Insurance Securities, Inc., 254 F. 2d 642 (9 Civ. 1958), cert. den., 358 U.S. 823 (1958), aff'g., 146 F Supp. 778 (1956).

increasing their fund's expense limitation and then recommending to shareholders ratification of the board's action retroactively. The staff, with the Commission's concurrence, recently informally indicated its view that such a board recommendation for retroactive approval of this material term of an advisory contract would be a violation of Section 36(a). Shareholders should not be presented with a fait accompli but should be allowed the opportunity of objective, detached reflection on material changes in contracts which affect the costs of operating their investment companies.

To a large degree, conflict of interest problems have existed since man first entrusted a portion of his property to another to manage on his behalf. As regulators, we would indeed be naive if we were to imagine that we could eliminate all such problems in the securities industry in the immediate future. Some of the measures I have described which we are taking at the federal level are, hopefully, reducing substantially the effects of the problems, especially upon investors who previously were not even aware of their existence. As a former state administrator and colleague in your association, I happily can add that, in many of these situations, you have an advantage over us federal securities authorities. That advantage lies in your power to review offerings under general standards of fairness and equity. I urge you to exercise that power freely, but, of course, prudently; for, reasonably used, it can be a great tool to prevent those conflict of interest abuses which we in Washington are not empowered to eliminate and against which mere disclosure may be, and in fact often times is, an inadequate protection.