ABUSE ON WALL STREET:

CONFLICTS OF INTEREST IN THE SECURITIES MARKETS

A TWENTIETH CENTURY FUND REPORT

ABUSE ON WALL STREET

Conflicts of Interest in the Securities Markets

Report to the Twentieth Century Fund
Steering Committee on Conflicts of Interest
in the Securities Markets

A Twentieth Century Fund Report

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THE TWENTIETH CENTURY FUND

The Twentieth Century Fund is an independent research foundation that undertakes policy studies of economic, political, and social institutions and issues. The Fund was founded in 1919 and endowed by Edward A. Filene.

Foreword

We are, to paraphrase Chesterton, all conflicted now. Anyone who is at all active in our society is confronted by conflicts of some sort, but most of us have little difficulty in resolving them in a responsible fashion. Certainly, the securities industry, where conflicts abound, has long had a heightened awareness of the problems it poses. Because the industry is dealing largely with other people's money, it has been the most scrutinized and the most supervised in terms of conflicts, real and potential. Yet there has been little in the way of sound and systematic research on the current state of conflicts in the securities markets—what they are, why they matter, and how to deal with them.

The Twentieth Century Fund, which almost from its beginnings took an active interest in the proper functioning of the securities markets, decided that this gap in our knowledge ought to be filled. In doing so the Fund was not motivated by a desire to engage in scandalmongering or headline hunting; neither was it concerned about theoretical or potential conflicts where the opportunity for exercising self-interest could conceivably be damaging to others. Rather, its main objective was to concentrate on situations in which actual and practical difficulties exist.

In carrying out this examination, the Fund established a steering committee, headed by Roy A. Schotland, professor of law at Georgetown University Law School; the committee, in turn, selected an experienced group of independent investigators to deal with specific areas of the securities markets. Each of the investigators had freedom to report on the situation as he found it, while the steering committee, after deliberating over the evidence, sought to provide a balanced perspective on conflicts and what ought to be done to mitigate them.

The findings of the investigators and the conclusions of the steering committee make clear that no pervasive problem of conflicts exists today. This should prove reassuring to all investors, including the millions who have an indirect stake through corporate or union pension funds. But if there is no need for radical reform, the fact is that the big increase in indirect investment and the expansion of financial firms have brought an increase in conflict situations and in their complexity that call for new protective measures. The most significant contribution made by the investigators was identifying actual conflicts—a prerequisite to establishing reasonable and effective safeguards against them.

Because the financial industry is so used to living with conflicts and so accustomed to observing rules that guide the exercise of fiduciary responsibility, the steering committee in its recommendations for reform strongly favored new voluntary measures for self-policing. Self-policing of course has not always worked as well as it should, but it remains preferable as a means of guiding ethical or responsible behavior than attempting to regulate such behavior through legislation or administrative fiat. Perhaps the main value of the entire examination is that it alerts both the financial industry and the public to the principal areas where abuses exist and suggests the kind of preventive medicine for them that, if administered in time, can help to maintain confidence in the integrity of the marketplace.

At a time when the financial industry is plagued with a great variety of problems and challenges, conflict situations may not appear to be of critical importance. But abuses in the handling of conflicts tend to engender distrust and suspicion more widely than other weaknesses or shortcomings. What is more, as the various reports demonstrate, conflicts are manageable, provided they are recognized and the will to manage them exists.

The Fund is grateful to each of the investigators—to Richard Blodgett, author of the *New York Times Book of Money*, who reported on union pension funds; to John Brooks, of *The New Yorker*, author of *The Go-Go Years* and other books on the securities markets, who reported on corporate pension funds; to Edward S. Herman, professor of finance at the University of Pennsylvania's Wharton School, who reported on commercial bank trust departments; to Louis M. Kohlmeier, a Pulitzer Prize-winning journalist, who reported on state and local public employee pension funds; to Martin Mayer, author of *The Bankers*, who reported on broker-dealer firms; to Chris Welles, author of *The Last Days of the Club*, who reported on nonprofit institutions; and to Nicholas Wolfson, of the University of Connecticut Law School, co-author of *Regulation of Brokers, Dealers, and Securities Markets*, who wrote on investment banking. Some of their reports were researched and written in the mid-1970s, and although they have been subject to some updating, they have not taken detailed account of more recent developments, most of which, partially as a result of their work, have been positive.

I want to pay a personal tribute to the members of the steering committee—William L. Cary, Dwight Professor of Law at Columbia University Law School and a former chairman of the Securities and Exchange Commission; Benjamin V. Cohen, the architect of most of the original legislation affecting the securities markets and a trustee of the Fund; Roger F. Murray, former S. Sloan Colt Professor of Banking and Finance at Columbia University; and William Stott, formerly vice-president in charge of investment at Morgan Guaranty Trust Company; and Roy A. Schotland. As one privileged to serve with the committee, I can attest to the thoughtfulness and conscientiousness of its members.

I want to offer special thanks to Roy A. Schotland, who was responsible for drafting the introduction and conclusions of the steering committee and also prepared the investigation of real estate investment trusts. He was unflagging in his industry and levelheaded in recognizing that, although conflicts cannot be eliminated, they can—and should—be reduced.

M. J. Rossant,
Director
The Twentieth Century Fund

May 1979

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by Roy A. Schotland

for the Steering Committee

I • INTRODUCTION

Many forms of conduct permissible in a workday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. . . .Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.[1]

Half a century has passed since Benjamin Cardozo, then chief judge of New York, set forth his now classic description of the obligation of the fiduciary to act fairly in the interests of his clients. A year later came the stock market crash of 1929, which led to the Securities Act of 1933 and the Securities Exchange Act of 1934, the most important and comprehensive securities market legislation in history.

Commenting on those events in 1934, Justice Harlan Fiske Stone said:

I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as Holy Writ, that "a man cannot serve two masters."[2]

Since those days the securities markets have operated reasonably efficiently and remained relatively free of scandal. Yet it is by no means clear that they have functioned as well as they might. In discussions at the Twentieth Century Fund in the early 1970s, a number of people with a great variety of involvements in the securities markets concluded that the "departure of the small investor, perhaps some of the volatility of the market, and certainly much of the prevailing cynicism about Wall Street might be traced to a widespread, though generally not perceived, concern over conflicts of interest within the financial community." The Fund sponsored this study in an attempt to assess