In the Matter of KIDDER, PEABODY & CO., INCORPORATED, EDWARD B. GOODNOW

Admin. Proc. File No. 3-1739, 801-4221

SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISORS ACT OF 1940, Release No. 232
SECURITIES EXCHANGE ACT OF 1934, Release No. 8426

October 16, 1968

TEXT: MEMORANDUM OPINION AND ORDER ACCEPTING OFFER OF SETTLEMENT

After conducting an inquiry into the conduct by Kidder, Peabody & Co., Incorporated (registrant) of an investment advisory service known as the Kidder, Peabody Special Investment Advisory Service (Special Service), our Division of Trading and Markets (Division) raised questions pertaining to whether certain activities of registrant and Edward B. Goodnow (Goodnow), a vice president of registrant and a manager of the Special Service, complied with the applicable provisions of the Securities Exchange Act of 1934 (Exchange Act) and the Investment Advisers Act of 1940 (Advisers Act).

While denying the allegations of the Division, in the interest of settling this matter registrant and Goodnow have submitted Offers of Settlement and, solely for the purpose of these Offers of Settlement, have agreed with the staff to Stipulations of Facts. The Offers of Settlement provide, among other things, that the Commission may make certain findings of facts and draw certain conclusions and inferences not inconsistent with the Stipulations of Facts, and that the Commission may censure registrant and Goodnow if it deems such sanction appropriate. Registrant and Goodnow have waived formal institution of administrative proceedings, a hearing, post-hearing procedures and the separation of functions between the staff and Commission in the preparation of the Commission order and opinion disposing of this matter.

The Stipulations of Facts entered into between the Division and registrant and Goodnow encompass the following facts among others:

(1) Goodnow was employed as a registered representative by registrant and its predecessor from 1952 until February 1967, and was a vice president of registrant from January 1963 until February 1967. Registrant's Special Service was organized by registrant, Goodnow, and others on or about April 1, 1960, and from that date until termination of the Special Service on February 21, 1967, provided continuous investment supervisory services to special advisory clients of the registrant. The Special Service was managed by a committee of officers and employees of registrant, including Goodnow. From its inception, Goodnow and another employee-officer of registrant had responsibility for day-to-day operation and administration of the Special Service until it was terminated in February 1967.

(2) Commencing in April 1962, the relationship between the Special Service and its clients was formalized in a special investment advisory contract which was entered into by each advisory client. Among other things, the contract provided that registrant could execute transactions in the Special Service on either a principal or agency basis. When unlisted securities were purchased for Special Service advisory clients on an agency basis, registrant charged advisory clients a commission equal to the equivalent minimum New York Stock Exchange commission. This was the same pricing practice that registrant employed when executing orders for unlisted securities for ordinary clients who did not participate in the Special Service. However, most purchases of unlisted securities for Special Service advisory clients were effected on a principal basis. In certain cases, registrant sold unlisted securities to, or purchased unlisted securities from, advisory clients in riskless or substantially riskless principal transactions charging the advisory clients mark-ups or mark-downs greater than the normal commissions that would have been charged had such purchase and sale transactions been executed on an agency basis. For instance, the average mark-up charged Special Service clients in the acquisition of over-the-counter securities in principal transactions, although generally within an agreed 3% limitation contained in the Special Service advisory contract, averaged 1.73 times what the charge would have

been had the transaction been executed on an agency basis. With respect to the transactions executed for Special Service advisory clients on a principal basis, neither the registrant's cost of securities sold nor the contemporaneous market price of the securities were disclosed to advisory clients.

(3) The advisor Goodnow and certain of his relatives participated in the Special Service. In the course of the last three years of operations in the Special Service, some securities were purchased or sold for Goodnow and certain of his relatives, shortly before they were purchased or sold for other unrelated clients of the Special Service, at prices which were more favorable than the prices paid or received for the same securities by such unrelated clients. Although certain of Goodnow's clients from time to time may have been informed generally that Goodnow was engaging in transactions in the same securities being recommended to them and acquired for their accounts, or that Goodnow had acquired a position in such securities, registrant did not adopt any specific policy of requiring specific disclosure of Goodnow's activities to clients unrelated to Goodnow, and no such disclosure was included in the printed recommendation and consent cards sent to clients in consummating transactions in the Special Service. Accordingly, when specific purchases or sales were made for individual advisory clients, such clients were not informed of the nature, terms and sequence of the purchase or sale for the personal account of Goodnow or for the accounts of Goodnow's relatives.

(4) While managing and participating in the Special Service, Goodnow arranged with a bank for the extension and maintenance of credit to himself for the purpose of purchasing and carrying unlisted and non-exempt securities through his account with registrant on terms and conditions which registrant could not lawfully extend or maintain under Regulation T of the Board of Governors of the Federal Reserve System.

The Division was of the view that the operation of the Special Service did not comply with Section 206 of the Advisers Act and Sections 10(b) and 15(c) of the Exchange Act and Rules 10b-5 and 15c1-2 thereunder as follows:

(1) When securities were sold in principal transactions to advisory clients of the Special Service, no disclosure was made to the clients of the cost of such securities to registrant or of the current market price;

(2) While the Division did not dispute that registrant purchased the securities at the best possible prices in the trading markets, the Division maintained that the prices paid for securities by advisory clients was not always the best available price since substantially riskless transactions which registrant could have handled on an agency basis were in certain cases executed on a principal basis at mark-ups or mark-downs greater than the commissions regularly charged by registrant on agency transactions;

(3) Goodnow, in the acquisition and liquidation of securities for Special Service accounts, executed certain transactions in a manner that resulted in preference to his own account and to certain accounts of his relatives and did not disclose such preferential transactions to the remaining advisory clients.

The Division was of the further view that Section 7(c) of the Exchange Act and Section 7(c) of Regulation T issued by the Board of Governors of the Federal Reserve System were not complied with, in that Goodnow arranged substantial purpose loans at a bank secured by unlisted securities, to finance certain of Goodnow's personal Special Service transactions.

Registrant and Goodnow urge certain factors in mitigation: The Special Service was terminated in February 1967. Registrant in its existing investment advisory service has undertaken to make full disclosure, in all principal transactions with advisory clients, of the registrant's cost of the securities sold and the current market price of such securities if the latter is more favorable than the price charged the client. Registrant and Goodnow point out that they relied upon advice of counsel in conducting the operations of the Special Service in the past without making such disclosures. n1 In addition, in order to eliminate any question as to the fairness of charges to its Special Service clients on principal transactions effected for their accounts, from and after the time when the Division first questioned registrant's procedures in this respect, registrant has voluntarily made payment in restitution to its former Special Service advisory clients of an amount equal to the difference between the mark-ups and

mark-downs they were charged on such transactions and the normal agency commissions thereon (i.e., the equivalent minimum New York Stock Exchange commission). Such payments, which aggregated $42,994, were made with respect to all principal transactions in over-the-counter stocks, other than those sold pursuant to a registered underwriting in which a prospectus was provided, during the period from December 1964 to February 1967. Registrant has also adopted an account identification system to facilitate the surveillance of transactions by registrant's officers and employees and their relatives in order to improve its supervisory procedures with respect to transactions in such accounts. Furthermore, registrant has adopted improved surveillance procedures in its cashier's department to assure that registered representatives and officers of registrant comply with Regulation T in arranging credit with outside lenders for the purpose of purchasing and carrying securities. Both registrant and Goodnow point out that during the last three years of the operations of the Special Service, the average special investment advisory account more than doubled in value. Goodnow states that he did not intend to accord preferential treatment to his personal account and that the timing of transactions in the Special Service was determined solely on the basis of his judgment as to investment suitability at a particular time for the accounts under his supervision. Goodnow further states that a comparison of the overall performance of his personal account and the accounts of his relatives with unrelated advisory accounts during the period that the Special Service was in existence, indicates that the average percentage gain of all unrelated clients of the service exceeded the average percentage gain of Goodnow and his family.

While we are mindful of the position of registrant and Goodnow, we nevertheless believe that it is important to emphasize at this time certain basic principles applicable to the activities involved in this case.

An investment adviser is a fiduciary who is required to serve the interests of his client with undivided loyalty. As a result, an investment adviser may not sell securities to his advisory clients in principal transactions unless he makes full disclosure of any adverse interest he may have and obtains the informed consent of his clients. The disclosure must include an explicit statement of the cost of the security to the adviser and the market price when more favorable. Neither a general or advance consent can be adequate because it is not based on knowledge of the specific facts in the transaction, and neither a waiver in an advisory contract nor any other circumstances will justify a departure from or a relaxation of these requirements. See, Investment Advisers Act Release No. 40 (February 5, 1945); cf., Arlene W. Hughes, 27 S.E.C. 629 (1948), aff'd sub nom., Hughes v. Securities and Exchange Commission, 174 F.2d 969 (D.C. Cir. 1940).

One of the basic duties of a fiduciary is the duty to execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances, cf., Thompson and McKinnon, Securities Exchange Act Release No. 8310 (May 8, 1968); Arlene W. Hughes, supra. This duty encompasses not only obtaining "best execution" in the marketplace, cf., Delaware Management Co., Inc., Securities Exchange Act Release No. 8128 (July 19, 1967), but encompasses the obligation of an investment adviser, who is a fiduciary, to execute transactions for advisory clients on an agency rather than a principal basis in instances where similar transactions for non-advisory clients normally would be executed on an agency basis at a commission less than the mark-up imposed when executing the transaction on a principal basis.

The Advisers Act was aimed at eliminating conflicts of interest between an investment adviser and his clients. Consequently, an investment adviser must not effect transactions in which he has a personal interest in a manner that could result in preferring his own interest to that of his advisory clients. Furthermore, whenever 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. Full disclosure of such potential conflict must be made to apprise the client of relevant facts so that the client is able to give his informed consent to transactions executed for the client, or to reject such transactions if he so desires. See, Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); Arlene W. Hughes, supra.

The provisions of Regulation T must be complied with when a registered representative of a broker-dealer finances personal stock transactions by obtaining "purpose loans" at a bank. Sutro Bros. and Co., 41 S.E.C. 443 (1963).

After due consideration the Commission has determined that it is in the public interest to accept the Offers of Settlement herein and accordingly

IT IS ORDERED that the Offers of Settlement be, and they hereby are accepted.

IT IS FURTHER ORDERED that Kidder, Peabody & Co., Incorporated and Edward B. Goodnow hereby are censured.

By the Commission (Chairman Cohen and Commissioners Owens, Budge and Smith), Commissioner Wheat not participating.

Footnote

n1 While reliance upon advice of counsel is a fact that may be taken into account in determining what sanctions are appropriate in the public interest, it does not excuse a failure to comply with applicable provisions of law. See, e.g., Dow Theory Forecasts, Inc., Investment Advisers Act Release No. 223 (July 22, 1968), pp. 10-11.