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Securities and Exchange Commission

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ATTORNEYS’ CONFLICTS OF INTEREST IN
THE INVESTMENT COMPANY INDUSTRY

Farrell C. Glasser*

Investment companies, more commonly known as mutual funds, have had a history of incestuous relationships which have thrived on conflicts of interest. It is currently common practice in the investment company industry for mutual funds and their affiliated management companies (advisers) and underwriters to retain the same legal counsel. Because of the unique relationships that exist in the investment company industry, this practice has in many instances had unfortunate consequences for the mutual funds involved. When a mutual fund has a legal right against its adviser or underwriter, or where an officer or director of the fund or the fund’s adviser breaches his fiduciary duty to the fund, it seems anomalous to permit the same attorney to represent both the fund and its affiliates in such traditionally adversary circumstances. Representation of these conflicting interests by the same attorney may hinder the effective determination, assertion, and

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1 A mutual fund is a specific classification of investment company, known as an open-ended company, which is prepared to redeem issued shares at their net asset value. Although there are three basic types of investment companies, by far the most prevalent is the mutual fund. Definitions of the various types of investment companies are found in the Investment Company Act of 1940, 15 U.S.C. §§ 80a-3 to -5 (1970) (Act).

2 Abraham Pomerantz, a noted attorney, has stated with respect to conflicts of interest in the investment company industry:

[O]f all dualities and of all conflicts on the American corporate scene, nothing—but nothing—approaches the open end mutual fund for incestuous relationships.

The fund is conceived by people whom we call advisers or managers.... This group gives birth to the fund. The fund is manned by the advisers.... [T]he umbilical cord is never cut after birth, as would be true in ordinary biological life.


3 See note 16 and accompanying text infra.

4 See text accompanying notes 6-16 infra.
effectuation of the legal rights of the fund in an adversary context.\(^5\)

This article explores the problem of conflicts of interest resulting from the retention of the same attorneys by investment companies and their affiliates. After an analysis of the problem, it suggests appropriate remedial measures that could be instituted to prevent these conflicts from occurring in the investment company industry.

1. THE INVESTMENT COMPANY INDUSTRY AND FEDERAL REGULATION

A. Inherent Conflicts of Interest in the Investment Company Context

It must be emphasized that there are significant differences between an operating company (such as an industrial corporation) and an investment company. The goals of the management and the shareholders of an operating company are usually the same: maximization of profits by minimization of the costs of production.\(^6\) In the case of an investment company, however, the goals of the fund and its shareholders on the one hand, and the goals of the affiliated adviser on the other hand, are not necessarily the same. The shareholders look to capital appreciation or current income or a combination of the two, while the adviser seeks to increase the advisory fee paid by the fund for managing its investment portfolio. The adviser's fee is not a function of the per share growth of an individual’s investment in the fund. Rather it is a function of the size of the net assets of the fund.\(^7\) As a result,

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\(^7\)Most funds pay an advisory fee amounting to .05 percent or more of the average net assets of the fund. The fee is based primarily on market quotations of the fund’s portfolio securities. It is computed on the basis of the average daily net assets of the fund at the close of business on each business day and is paid monthly, quarterly, or over some other period. In addition to payment of advisory fees, there has recently been a trend in the industry toward the use of performance fees. Investment Advisers Act of 1940 § 205, 15 U.S.C. § 80b-5 (1970), states that performance fees must be based on the asset value of the company or fund under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices . . . . The point from which increases and decreases in compensation are measured shall be the fee which is paid or earned when the investment performance of such company or fund is equivalent to that of the index . . . . Fund advisers have been able to structure these performance fees so that the adviser is
one way the adviser can maintain or increase his fee is to encourage the underwriter, who is usually an affiliate of the adviser, to increase the sale of fund shares, which will in turn increase the amount of fund net assets. The advisory fee can in this way be maintained or increased even in times of declining stock prices or when poor investment decisions by the adviser result in a decline in the value of the fund’s investment portfolio.

An investment company is to be distinguished further from an operating company in that the typical fund conducts its business by means of an advisory agreement that outlines the relationship between the fund and its adviser. Usually these agreements stipulate that as consideration for payment by the fund of an advisory fee the adviser will furnish the fund with “investment advice and assistance, office space and facilities . . . , pay all compensation for personnel of the [fund] or [adviser] performing services relating to research, statistical and investment activities and pay the salaries and fees of all officers and directors of the [fund.]”8 In many instances the officers and directors of the adviser also serve as officers and directors of the fund, except where proscribed by statute.9 In some instances the adviser is affiliated not only with the fund’s underwriter, but also with the registered broker-dealer who executes the transactions for the funds portfolio.

The conflicts of interest which are indigenous to the fund’s relationship with its affiliates are unparalleled when compared with those conflicts which arise out of the typical operating company’s relationships. For example, because the members of the

8 Prospectus of Salem Fund, Inc. at 3 (March 31, 1972). In many cases, the directors and officers of the fund are paid nominal salaries by the fund itself. Since the directors and officers who are affiliates of the adviser are usually paid a substantial salary by the adviser for their services as employees of the adviser, situations involving conflicts of interest can develop readily. To exacerbate the conflict of interest problem, in some instances the adviser pays the salaries of the unaffiliated disinterested directors. It has recently been disclosed in the proxies and prospectuses of the Fidelity Group of Funds, a complex of fifteen funds, that the adviser, Fidelity Management and Research Company, pays each unaffiliated director approximately $25,800 a year for managing all of the funds in the complex. Each director serves on the board of directors for all of the funds in the complex. The payment of such sizeable fees to the unaffiliated disinterested directors can only serve to diminish the objectivity of these directors in representing the interests of the shareholders of the funds. See note 36 and accompanying text infra for a definition and description of disinterested directors.

fund's board of directors and its adviser are generally the same, the consent of the fund's board to the investment decisions of the adviser often may be perfunctory. In addition, genuine arm's length bargaining over matters such as the advisory fee or the terms of the advisory agreement is difficult because the fund is represented either by those with an interest directly contrary to that of the fund or by persons under the influence of those with a contrary interest. Competitive forces do not exist in the investment company industry with respect to the advisory fee. Rather, there is a seller's market in which an adviser "wearing one hat, sets his own fee without fear that the fund's board, on which he wears his other hat, can or will bargain effectively with him, much less actually shop around for competitive offers." Among the conflicts of interest involving the fund that can develop are: first, the fund may place its brokerage business with a broker-dealer who performs services for or is affiliated with the fund's adviser; second, the broker-dealer employed by the fund may have a financial interest in the volume of portfolio transactions which he executes for the fund; third, the fund's underwriter may be too concerned with considerations relating to sales and salability of the fund's shares; and fourth, a director or officer of the fund may make purchases or sales of securities that are also held by the fund.

It is clear that in many instances the interests of the fund and its adviser are divergent. Yet it is often the case that the fund is represented or serviced by counsel retained by the adviser.

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10 See generally Jaretzki, Duties and Responsibilities of Directors of Mutual Funds, 29 LAW & CONTEMP. PROB. 777 (1964).
11 The conflict between the adviser-director's duty to the fund shareholders to keep the advisory and other fees as low as possible and his own self-interest in maximizing them [exists in many situations]. [In the case of . . . a publicly-held adviser a duty to maximize [the adviser's] profits—at the expense of the fund—runs from those in control of the adviser to its own shareholders. Thus, the adviser's representative on the fund's board must constantly face pressures from the public shareholders of the investment adviser which conflict with his duties to the public shareholders of the fund.
12 See Comment, supra note 2, at 432-33.
13 The larger the volume of transactions the greater the amount of commissions received by the broker. This creates a tendency for the broker to "churn" the account in an attempt to create more commissions.
14 Jaretzki, supra note 10, at 789.
Where the same attorney represents both the fund and its affiliates, the attorney is placed in a position in which he may be required to represent and advocate interests which are truly adverse. It is axiomatic in a situation where gain for one client is loss for another that counsel cannot maximize the interests of both clients.

B. The Investment Company Act of 1940

It is apparent that in situations such as those discussed above, the interests of investment company shareholders can be undermined. The shareholders, taken as a group, own the investment company itself and will prosper or fail in relation to its investment performance. In contrast the organizers and promoters of the fund own the management and sales organizations, and their prosperity will be a function of the ability of these persons to generate sales and commissions and to build the size of the fund. It was in response to these differing interests that Congress enacted the Investment Company Act of 1940 (Act).

In one provision designed to combat the disregard by the management for the interests of the fund shareholders, Congress defined the term “affiliated person.” By limiting the roles such affiliated persons could play in the fund, Congress attempted to make investment companies more responsive to their shareholders. The Act thus indicates precisely what degree of relationship among the fund, management, and the investment adviser will engender conflicts of interest. Under Section 10 of the Act, at


18 This results from the fact that fund management fees are calculated as a percentage of assets. N.Y. Times, Sept. 12, 1971, § 3 at 3, col. 3.

19 15 U.S.C. § 80a-2(a)(3) (1970) defines “affiliated person of another person” to be: (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

20 Public Policy Implications, supra note 16, at 130–31. Abraham Pomerantz, com-
least 40 percent of the directors of a registered investment company are prohibited from being investment advisers or persons affiliated with the adviser. In addition, a majority of fund directors is forbidden from acting as the principal underwriter, broker, or investment banker for the fund. Nor is an investment company allowed to have a majority of its board of directors composed of persons who are officers or directors of any one bank. The theory of the provisions regarding affiliated persons is two-fold: first, all fund transactions should be scrutinized by at least a minority of directors who are independent from the management; and second, where director affiliations could involve conflicts of interest, a majority of independent directors assures the shareholders of some degree of protection. The legislative intent behind the creation of these independent directors was to impose a buffer between the investment adviser and the shareholders of the fund. It was believed that these directors would be responsive to the needs of the fund and would objectively review the operation of the fund in order to diminish conflicts of interest. Although all the directors of the fund have a fiduciary duty to the fund’s shareholders, it was felt that the independent directors would be in the best position to insure that this duty was effectively carried out. Even with this provision for unaffiliated directors, however, the shareholders of investment companies have not been objectively represented.

Section 17 was specifically incorporated into the Act as a legislative attempt to resolve the problem of conflicts of interest in the investment company industry. The provisions of that section interpose the Securities and Exchange Commission (Commission or SEC) between the fund and any affiliated person who desires to consummate a purchase or sale of property with the fund; upon application the SEC may exempt certain transactions from the prohibition. Subsection 17(d) prohibits certain transactions in

23 Id. § 80a-10(b).
24 Id. § 80a-10(c).
27 For a discussion of the fiduciary obligations of directors, see part IV infra.
28 See text accompanying notes 131–47 infra. See generally Comment, supra note 2; Comment, supra note 5, at 701. See also PUBLIC POLICY IMPLICATIONS, supra note 16, at 130–31.
30 Id. §§ 80a-17(a), (b).
which an affiliated person and the fund propose to act jointly.\textsuperscript{31} The Commission is given statutory authority to review these joint transactions and determine the extent to which participation by the fund is on a basis different from or less advantageous than that of any other participant.\textsuperscript{32} When fund advisers utilize reciprocal arrangements in connection with brokerage generated by portfolio transactions, Subsection 17(e) provides that affiliates acting as agents\textsuperscript{33} may not receive any compensation in such transactions other than regular salary from the fund, except in the course of their business as a broker or underwriter.\textsuperscript{34}

\textbf{C. Investment Company Amendments Act of 1970}

In 1970 Congress amended the 1940 Act by enacting the Investment Company Amendments Act of 1970 (Amended Act).\textsuperscript{35} One important change from the 1940 Act was to broaden the requirement that 40 percent of the directors be unaffiliated to the requirement that these directors also be disinterested.\textsuperscript{36} The term "interested director" includes members of the immediate family of any natural person who is affiliated with the fund; interested persons\textsuperscript{37} of any investment adviser or princi-

\textsuperscript{31} Id. § 80a-17(c).

\textsuperscript{32} See In the Matter of Massachusetts Mutual Life Ins. Co., Investment Company Act Release No. 6634 (July 22, 1970). The granting of an order in this case by the Commission represents the first time that the Commission has permitted a blanket exemption for a pattern of transactions under Subsection 17(d). However, if any variation occurs from the strict conditions of the order granting the application, a new application must be filed and acted upon by the Commission. Thus, when there is a possibility that any conflict of interest may arise, the Commission has reserved its statutory authority to review the transaction to assure fair treatment for the fund and its shareholders.

\textsuperscript{33} 15 U.S.C. § 80a-17(e) (1970). Brokers who effectuate these transactions on behalf of a fund are acting as agents for the fund.


\textsuperscript{36} 15 U.S.C. § 80a-10(a) (1970). See Comment, supra note 5, at 703–20. The duties of the disinterested directors are to:

\begin{enumerate}
  \item evaluate investment advice provided by the adviser;
  \item determine quality of service provided in relation to performance;
  \item inform themselves as to the functions of the investment adviser;
  \item determine what changes could be made that would benefit fund shareholders;
  \item study the advisory fee to see if it is reasonable;
  \item compare expense ratio of fund with other funds whose size and objectives are similar, but whose advisory function is internally generated; and
  \item determine the costs the adviser incurs in providing services to fund to see if his fee is too high.
\end{enumerate}

These, of course, are by no means all the duties of the disinterested director, but are a sample of the type of service he should be providing the fund. See generally Mundheim & Nutt, The Independent Directors of Mutual Funds, WHARTON Q., Spring, 1972, at 6.

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pal underwriter of a fund; and legal counsel for the fund, the investment adviser, or the principal underwriter of the fund during the past two fiscal years; it further includes partners or employees of counsel and other persons. In addition, Congress has given the SEC power to issue orders declaring a party interested under certain circumstances. The SEC is also given the power to exempt a party from the Act’s restrictions on board membership upon an appropriate showing that the person is in a position to act independently on behalf of the investment company and its shareholders in dealing with the adviser or principal underwriter. Congress expressly intended that the SEC should adopt a broad interpretation of the term “interested person.”

Another significant amendment to the 1940 Act concerns the power of the SEC to bring injunctive actions against the fund’s affiliates pursuant to Subsection 36(a). Prior to the amendment of Subsection 36(a), these actions were permitted only in cases involving “gross abuse of trust” or “gross misconduct” on the part of the fund’s affiliates. Because this standard was too inflexible for courts to administer, shareholders of investment companies could not be assured that the Act offered adequate protection against unscrupulous affiliates. Under the 1970 amendment of Subsection 36(a), the Commission can now bring an injunctive action against the affiliates of an investment company if they have engaged or are about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

1. as officer, director, member of any advisory board, investment adviser, or depositor; or
2. as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of policies declared in section 80a-1(b) of this title.


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39 Id. § 80a-6(c).
41 15 U.S.C. § 80a-35(a) (1970) states:

The Commission is authorized to bring an action in the proper district court of the United States, . . . alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

1. as officer, director, member of any advisory board, investment adviser, or depositor; or
2. as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of policies declared in section 80a-1(b) of this title.
II. INDEPENDENT COUNSEL AND THE CODE OF PROFESSIONAL RESPONSIBILITY

A. The Code of Professional Responsibility

In order to understand the role that the attorney should play in representing the fund and its adviser or underwriter, it is helpful to look at the guidelines which the American Bar Association has adopted with regard to conflicts of interest resulting from dual representation by attorneys. The newly adopted Code of Professional Responsibility (Code) is comprised of Canons, Ethical Considerations, and Disciplinary Rules. The Code provides the basic precepts of ethical conduct to be applied by the attorney. An examination of selected provisions will assist in analyzing the problems associated with practice in the investment company context.

Canon 5 contains several Ethical Considerations that the attorney should strive to follow in his representation of clients:

Maintaining the independence of professional judgment required of a lawyer precludes his acceptance or continuation of employment that will adversely affect his judgment on behalf of or dilute his loyalty to a client. This problem arises whenever a lawyer is asked to represent two or more clients who may have differing interests, whether such interests be conflicting, inconsistent, diverse, or otherwise discordant.

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43 See text accompanying notes 124-29 infra.
45 Canons are stated to be:

statements of axiomatic norms, expressing in general terms the standards of professional conduct expected of lawyers in their relationships with the public, with the legal system, and with the legal profession. They embody the general concepts from which the Ethical Considerations are derived.

ABA CODE OF PROFESSIONAL RESPONSIBILITY, PRELIMINARY STATEMENT [hereinafter cited as CODE].

46 Ethical Considerations are "aspirational in character and represent the objectives toward which every member of the profession should strive. They constitute a body of principles upon which the lawyer can rely for guidance in many specific situations." Id.

47 "The Disciplinary Rules, unlike the Ethical Considerations, are mandatory in character. [They] state the minimum level of conduct below which no lawyer can fall without being subject to disciplinary action." Id.

48 CODE, Canon No. 5.
49 CODE, Ethical Consideration No. 5-14 (emphasis added). Ethical Consideration 5-15 provides:
The former Canons of Professional Ethics\(^\text{50}\) defined conflicting interests as those which occur "when, in behalf of one client, it is his duty to contend for that which duty to another client requires him to oppose."\(^\text{51}\) The new concept of "differing interests" appears to be broader and more inclusive than the old concept of conflicting interests.

The Code implies that an attorney can continue to represent differing interests so long as there is full disclosure to all clients and their consent to such representation is obtained.\(^\text{52}\) In the investment company industry, however, dual representation should not be permissible. The attorney for the fund is usually retained by the management company, which pays his salary and to which he is ultimately responsible.\(^\text{53}\) Counsel's loyalty, whether consciously or unconsciously, is directed primarily toward the management company and not toward the fund. Professor Mundheim has commented regarding former Canon 6 that "the Canons' simple prescriptions for dealing with conflicts of interest often seem to ignore the practical demands of corporate life. Frequently it would be silly to follow their directions literally."\(^\text{54}\) Professor Mundheim also noted that under circumstances such as those encountered in the corporate situation, courts have said the disclosure of conflicts and some measure of consent by the client is

\[\text{If a lawyer is requested to undertake or to continue representation of multiple clients having potentially differing interests, he must weigh carefully the possibility that his judgment may be impaired or his loyalty divided if he accepts or continues the employment. He should resolve all doubts against the propriety of the representation . . . . (emphasis added).}\]

Ethical Consideration 5-16 states:

[Where] a lawyer is justified in representing two or more clients having differing interests, it is nevertheless essential that each client be given the opportunity to evaluate his need for representation free of any potential conflict and to obtain other counsel if he so desires. Thus before a lawyer may represent multiple clients, he should explain fully to each client the implications of the common representation and should accept or continue employment only if the clients consent . . . .

Ethical Consideration 5-18 states:

A lawyer employed or retained by a corporation or similar entity owes his allegiance to the entity and not to a stockholder, director, officer, employee, representative, or other person connected with the entity. In advising the entity, a lawyer should keep paramount its interests and his professional judgment should not be influenced by the personal desires of any person or organization . . . .

\text{See also Canon 9 of the Code.}\]

\(^{50}\) See note 44 \textit{supra}.\]

\(^{51}\) ABA CANONS OF PROFESSIONAL ETHICS No. 6.\]

\(^{52}\) See Ethical Consideration 5-16, \textit{supra} note 49.\]

\(^{53}\) See note 16 and accompanying text \textit{supra}.\]

not sufficient to permit counsel to represent adverse interests.\textsuperscript{55} Judge McGowan feels that disclosure of conflicts to the client simply shifts the burden of avoiding or approving the conflict to the client.\textsuperscript{56} He suggests that this is unrealistic, because "it is [not] the client who can best make the decision as to whether there is a harmful conflict, even though he knows all the facts."\textsuperscript{57}

There would seem to be only two viable solutions to this problem of conflicts of interest. First, the lawyer should determine when a conflict exists and should advise the client that separate counsel should be retained; or second, in the case of investment companies especially, independent counsel should be retained when the relationship between the fund and the management company first comes into existence. Judge McGowan has also noted that representation of multiple clients raises a problem with respect to possible future conflicts arising out of a present transaction which involves no conflict.\textsuperscript{58}

It is not uncommon in the investment company industry for one attorney or firm of attorneys to represent both the fund and its adviser or other affiliates.\textsuperscript{59} In addition, the board of directors of the fund and its officers are usually, except as regulated by statute, comprised of officers and directors of the adviser or underwriter.\textsuperscript{60} In many instances the unaffiliated directors of the fund are paid for their services by the adviser.\textsuperscript{61} Situations often develop where the director-officers who are paid by the adviser have interests which are contrary to those of the fund, as for example where a derivative suit has been instituted against the director-officer. The attorney representing the fund in this action may also be paid by the adviser. In this situation for whom is the attorney an advocate?\textsuperscript{62} It is not humanly possible in such situations for counsel to represent both interests fairly and equitably, even where full disclosure is made to both sets of clients. Investment companies for the most part are publicly held corporations with an obligation to their shareholders. In addition, dual representation, even with disclosure, would appear to be violative of Canon 9, under which even the appearance of impropriety may be sufficient to warrant retention of independent counsel.\textsuperscript{63}

\textsuperscript{55} See Mundheim, supra note 54, at 226 n.16; W.E. Basset Co. v. H.C. Cook Co., 201 F. Supp. 821 (D. Conn. 1962).
\textsuperscript{56} UNIVERSITY OF CHICAGO LAW SCHOOL, CONFERENCE ON CONFLICT OF INTEREST 13, 15 (Conference Series No. 17, 1961).
\textsuperscript{57} Id.
\textsuperscript{58} Id. at 16.
\textsuperscript{59} See text accompanying note 16 supra.
\textsuperscript{60} PUBLIC POLICY IMPLICATIONS, supra note 16, at 74.
\textsuperscript{61} See note 8 and accompanying text supra.
\textsuperscript{62} See Ethical Consideration 5-18, supra note 49.
\textsuperscript{63} Canon 9 of the Code treats the matter of public confidence in a lawyer.
Considerations of expeditious handling and expense and the dubious belief that one can represent both sides of a transaction fairly are often used as convincing arguments for dual representation. It is unrealistic to expect that counsel hired by the management company could act with complete independence on behalf of the fund in a transaction with the management company, e.g., the drawing up of the advisory agreement or determining the management fee. The retention of independent counsel at the inception of the fund's relationship with its adviser or underwriter would ensure that the judgment and advice of counsel on behalf of the fund would be truly independent of the influence of the adviser.

B. Applicable Case Law

In recent cases concerning the issue of dual representation by counsel, the courts have consistently held that an attorney may not represent different interests which are hostile or in conflict with one another. In borderline cases of conflicts of interest doubts should generally be resolved in favor of disqualification. In most cases the issues are not sharply defined, and a facile determination of what constitutes conflicts of interest is not possible. Corporate and labor union litigation has provided an active arena for disputes involving the issue of conflicts of interest arising out of dual representation by counsel of both individual defendants and the corporation or labor union. In these cases the courts have uniformly held that independent counsel is required.

Professor Kaplan has noted with respect to dual representation by counsel that:

[T]he lawyer is certainly in no position to battle vigorously on behalf of any party to the transaction as an advocate unless he is previously committed to one party primarily, in which case he is certainly unlikely to battle vigorously against his primary client (the management company). The lawyer in such a situation either unfairly acts against the interests of one of his clients or is emasculated as an advocate and cannot [sic] act only as a neutral resource person.

PRACTICING LAW INSTITUTE THIRD ANNUAL INSTITUTE ON SECURITIES REGULATIONS, CONFLICT OF INTEREST IN CORPORATE LAW PRACTICE 207 (1971) (remarks of Professor Kaplan) [hereinafter cited as Kaplan].

64 See Brasseaux v. Girouard, 214 So. 2d 401 (La. 1969).

65 The noted case, Milone v. English, 306 F.2d 814 (D.C. Cir. 1962), involved the Labor-Management Reporting Disclosure Act of 1959, 29 U.S.C. § 501(b) (1970), which enables a member of a union to bring an action in behalf of his union against any officers of that union who have been derelict in their duty. The Act gives the members of unions powers which resemble a shareholder's right to maintain a derivative action against corporate management. The court here held that

[counsel who are chosen by and represent officers charged with... misconduct, and who also represent the union, are not able to guide the litigation in the best interests of the union because of the conflict in counsel's loyalties. In such a situation it would be incumbent upon counsel not to represent both the union and the officers.

306 F.2d at 817. See also Lewis v. Shaffer Stores Co., 218 F. Supp. 238 (S.D.N.Y. 1963); Elberta Oil Co. v. Superior Court, 108 Cal. App. 344, 291 P. 668 (1930); Garlen v. Green
Lewis v. Shaffer Stores Co.\(^6^7\) involved an action brought by a shareholder of a corporation against the officers, directors, and a majority shareholder of that corporation. Plaintiff asked for recovery of short-swing profits resulting from the individual defendants' purchase and sale of securities of the corporation and also for recovery of losses allegedly incurred by the company as a result of certain transactions initiated under the defendants' control. A single law firm retained by the corporation represented the company and the individual defendants in the action. Defendants filed a joint answer denying all charges of wrongdoing. Plaintiff moved that the law firm should not be permitted to continue its representation of all defendants and requested that the corporation be represented by "genuinely independent counsel."\(^6^8\) The court granted plaintiff's motion and stated that the corporation should "retain independent counsel, who have no previous connection with the corporation, to advise it as to the position which it should take in this controversy."\(^6^9\) Counsel representing the individual defendants could not represent the corporation because it was evident that the interests of the officers, directors, and the majority shareholder were "clearly adverse . . . to the interests of the stockholders of [the corporation] other than defendants."\(^7^0\) This rationale is equally applicable to derivative actions brought by shareholders of investment companies.

In Murphy v. Washington American League Baseball Club\(^7^1\) an action was brought by a minority shareholder for the purpose of invalidating salary increases for board members voted by the company's board of directors. The corporation and a director were made defendants. The corporation and a director were represented by the same counsel, who filed a joint answer in their behalf, defending the action on the merits. The court noted that the corporation had authorized the payment of all legal fees arising out of the action. The court then ruled that counsel's dual
representation raised a serious question. Referring to its decision in *Milone v. English*, the court emphasized that the evils associated with dual representation must be prevented whether the dual representation is a result of union litigation or a shareholder derivative suit. The court held that the corporation and the individual defendants should retain separate counsel.

In *International Brotherhood of Teamsters v. Hoffa* an action was brought by members of a labor organization against union officials who were charged with a breach of fiduciary duty. In this action the same attorney represented both the union and the officials who were charged with misconduct. The court ruled that the union was entitled to "representation of its institutional interests by independent counsel, unencumbered by potentially conflicting obligations..." The court was not persuaded by defendants' contention that the similarity of the defenses offered by the organization and the individual defendants eliminated possible conflicts of interest. The court further stated, "Potential, no less than actual, conflict disqualifies counsel from serving in a double capacity..." The court went on to say that if the interests of the two parties became seriously adverse, and the responsibilities of counsel conflicting, this duality would be untenable regardless of how objective counsel attempted to be.

Recently, in *Yablonski v. United Mine Workers of America*, the United States Court of Appeals for the District of Columbia held that the regular law firm employed by the union must be disqualified from representing it in a lawsuit brought by the late Joseph A. Yablonski and other dissident members of the union against the union and three of its officers for misappropriation of certain funds.

The court did not consider it necessary to determine whether an actual conflict of interest existed. It thought that the public interest required that the validity of the allegations of breach of fiduciary duty against the union management should be determined in a context free from even the appearance of any potential conflict of interest in the representation of the union. The court

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72 Id. at 397.
74 324 F.2d at 398.
76 Id. at 256.
77 Id.
78 Id. at 257.
80 448 F.2d at 1180.
noted that the lawsuit was actually a derivative action, brought for the benefit of the union, and that the case must be viewed in the light of several pending cases alleging similar types of misconduct on the part of union officers, in which counsel was defending the individual officers. The court then held that under the circumstances the best interests of the union would be served by the disqualification of regular union counsel.

There is a close correlation between the relationships of the union management toward its members and of the directors of a mutual fund toward its shareholders. Both have fiduciary duties which are owed to the members or shareholders. Furthermore, both union members and mutual fund shareholders have a direct financial interest in the outcome of litigation brought by individual members or shareholders on behalf of the organization. In both situations, although the organization is a nominal defendant, it will benefit, as will the individuals who are members of the group. Both actions are in the nature of a derivative suit brought by a shareholder on behalf of the corporation. Thus, the situation in which counsel represents both the union and the individual officers of the union in a single action seems closely analogous to a situation in which counsel for an investment company represents both the fund and its adviser in the same proceeding.

Kohn v. American Metal Climax, Inc. arose as a result of the decision of the Zambian government to nationalize its domestic copper reserves and refining operations. Roan Selection Trust, Ltd., of which 42 percent was owned by American Metal Climax, entered into an agreement with Metal Climax for amalgamation of the two companies in order to prevent all of its property from being taken over. Suit was brought by a shareholder to enjoin the amalgamation of the two corporations on the ground that the disclosure provisions of the Securities Exchange Act of 1934 had been violated. The law firm which had represented both

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81 Id. at 1182.
82 Id.
83 The Yablonski court specifically said:

We think the analogy of the position of a corporation and its individual officers when confronted by a stockholder derivative suit is illuminating here . . . . Certainly no corporate counsel purports to represent the individual officers involved, neither in the particular derivative suit nor in other litigation by virtue of which counsel necessarily must create ties of loyalty and confidentiality to the individual officers, which might preclude counsel from the most effective representation of the corporation itself. The corporation has certain definite institutional interests to be protected, and the counsel charged with this responsibility should have ties on a personal basis with neither the dissident stockholders nor the incumbent officeholders.

Id. at 1181.
Metal Climax and Roan for over thirty-five years continued to represent both companies after the amalgamation was proposed. Plaintiff alleged that this dual representation was not disclosed to shareholders. While this conflict had been approved by Roan’s board of directors, the district court thought the approval meaningless because of the control Metal Climax had over Roan and its board of directors.86

Although the district court in the *Metal Climax* case held that disclosure of conflicts of interest is a prerequisite in merger cases, disclosure alone would not be effective to prevent conflicts in the case of investment companies because of the unique variety of conflicts which exist in the industry.87 The very nature of the relationship between the adviser and the fund assures that there are significant possibilities of antagonistic interests. An attorney who represents both the adviser and the fund can hardly be expected to be objective in his judgment and employment of skills. Disclosure and consent are effective tools only when the multiple interests represented are not significantly divergent.88

On appeal the Court of Appeals for the Third Circuit held that the proxy material used by Roan to obtain shareholder approval of its amalgamation with Metal Climax violated Rule 10b-589 and that relief of some kind should be afforded Roan’s minority share-

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86 The court stated:

[Counsel] thus placed itself in a clear position of conflict of interest. Though this position is sought to be justified because the RST directors agreed to allow [counsel] to continue to represent it notwithstanding the conflict, such agreement is meaningless in view of AMAX’s control of RST and the RST Board. Nevertheless, even assuming that [counsel] could continue to represent both, their position is a material fact which should have been disclosed to the shareholders. It would be important for shareholders, in evaluating the advice of RST directors to vote in favor of the amalgamation, to know that... RST was being advised by lawyers who were also advising AMAX. 322 F. Supp. at 1362.

Professor Kaplan has commented on this decision as follows:

There seems no doubt that counsel in this situation was representing both sides in an adversary transaction and that the general principles of the *Code of Professional Responsibility* would forbid such representation in the absence of appropriate disclosure and assent. The court quite sensibly took the position that consent granted by the board of directors of the subsidiary was ineffectual and that presumably such consent could only have been given by the subsidiary’s minority shareholders after appropriate disclosure to them... [T]he court’s remarks, though dicta, may be tantamount to saying that counsel should not have acted on behalf of both sides of the amalgamation proceedings... The principle deducible from the court’s disapproving remarks concerning dual representation in the AMAX case, where the conflict was openly apparent, would also seem to apply to many other types of transactions in which a corporation and its management are frequently represented by corporate counsel.

Kaplan, *supra* note 64, at 207.

87 See text accompanying notes 2-16 *supra*.

88 See Kaplan, *supra* note 64, at 207.

89 17 C.F.R. § 240.10b-5 (1972).
holders. The court reversed the lower court with regard to the finding that counsel had placed itself in a situation involving a conflict of interest by representing both parties to the amalgamation. Instead, the court held that the record did not support the lower court's finding that activities of counsel created a conflict of interest which the defendants were obligated to disclose. The basis for the court's rejection of the lower court's holding was that the district court had misconstrued "the factual premise that the firm was in a conflict of interest position with respect to the negotiation of the terms of the amalgamation." In fact, the court noted, the conflict only arose when Metal Climax and Roan commenced negotiations for the amalgamation. The court emphasized that when negotiations began counsel immediately advised Roan that it could not represent it in negotiations and Roan retained new counsel for the purposes of the amalgamation bargaining. It is significant to note that the court's holding does not vitiate the need for independent counsel when conflict arises from dual representation but rests solely on the factual issue that during the period when counsel was representing Roan there was no conflict arising out of such representation. It can be assumed that if counsel had continued to represent Roan without disclosure during the period when the conflict would have existed, conduct of counsel would have been censurable.

III. Analogies to Other Areas of Securities Work

In analyzing the problem of the same counsel's representing both the investment company and its affiliates, it is productive to study other areas of securities work where analogous problems have arisen. Escott v. BarChris Construction Corp. is illustrative of such problems. BarChris sold debentures to the public pursuant to a registration statement. The company subsequently went into bankruptcy. Debenture holders brought an action under Section 11 of the Securities Act of 1933, alleging that the

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90 458 F.2d at 269-70.
91 Id. at 268-69.
92 Id. at 269.
93 Id. at 267.
94 See text accompanying notes 117-18 infra.
96 15 U.S.C. § 77k (1970). Section 11 holds civilly liable as a result of a false registration (1) all signers of registration statements; (2) directors; (3) accountants, engineers, or professional persons having worked on registration statements; and (4) underwriters. Section 11 establishes, however, a defense of due diligence for all persons other than the issuer who shall prove: (1) regarding information in the registration statement prepared by nonexperts, that reasonable investigation was used to determine if the statements were true; and (2) concerning representations made on authority of an expert, that it was
registration statement contained material inaccuracies and omissions. The court stated that the impression created by the registration statement was that the company was "in a continuous ascendency of business." Party defendant included the company, its directors, certain corporate officers, the underwriter, and the company's auditors.

In terms of conflicts of interest, the salient point in BarChris was that one of the directors of BarChris was also counsel to the company in matters pertaining to its registration statement. Suit was brought against him as a director and as a signer of the registration statement. The court expressly stated that the action was not for malpractice against the attorney in his capacity as a lawyer. The court thought, however, that in considering the attorney-director's defense of due diligence the unique position which he occupied could not be disregarded. Since he was the director most concerned with preparing and assuring the accuracy of the registration statement, more was required of him in terms of reasonable investigation than could fairly be expected of another director. Although the attorney-director had not made intentional misrepresentations in the registration statement, his duty to BarChris's shareholders was to make a reasonable investigation into the information supplied him. By not making an appropriate investigation he failed to exercise due diligence as required by the Securities Act.

The conflicts in BarChris are unmistakable. The attorney owed a duty to the management of the company which retained his law firm. In addition, as a director of the company, he owed a duty to the shareholders of BarChris to represent their interests. In the BarChris case these loyalties clearly were not in harmony: one duty obliged him to disclose fully, the other to serve the goals of management. As a result of cases such as BarChris it has been suggested that attorneys should not serve as directors of those companies for which they act as counsel, but rules regulating such conduct have never been adopted.

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97 283 F. Supp. at 683.
98 Id. at 690.
99 Id.
100 Id.
101 Id.
102 Id. at 692.
103 15 U.S.C. §§ 77k(b), (c). See part IV infra.
104 See Hyatt, All in the Family: Dealings of Executives with their Own Firms Gets Closer Scrutiny, Wall Street J., Aug. 8, 1972, at 1, col. 6.
The SEC recently brought an action against National Student Marketing Corporation, the corporation's law firm, and the corporation's accounting firm, alleging violations of the antifraud provisions of the federal securities laws. The suit arose out of a number of activities, including the allegedly illegal issuance of National Student Marketing stock, falsification of earnings and other financial reports, and misrepresentation of the condition of companies involved in the merger. On October 31, 1969, National Student Marketing merged with Interstate National Corporation. Allegedly, this merger was consummated without the accountant's comfort letter's conforming with statements in the merger agreement. The comfort letter outlined changes in the financial statements of National Student Marketing which, if made, would have reduced net earnings by a substantial amount. Moreover, it is alleged that the adverse comfort letter was not disclosed to public investors or the shareholders of National Student Marketing and Interstate National, although the defendants knew shareholder approval of the merger had been obtained on the basis of materially false and misleading financial statements. The SEC additionally charged that the accountants amended their comfort letter before the merger took place by stating that National Student Marketing had a deficit for the period, and that defendants failed to inform the other persons present at the closing of this amendment. It is further alleged that the accountants proposed to counsel that the comfort letter be corrected but that counsel did not communicate this proposal to Interstate National. Subsequently, counsel issued an opinion which stated that all necessary steps had been taken to consummate the merger and that National Student Marketing had not violated any federal or state statute or regulation.

The essence of the SEC's case is its assertion that the attorneys should not have issued their opinion but should have insisted that the financial statements be revised and the shareholders resolicited. In addition, the SEC departed from traditional concepts of the attorney-client privilege by asserting that counsel should have ceased their representation of their clients and notified the SEC as to the misleading nature of the financial statements.

107 Id. at A-2.
108 Id.
109 Id.
110 It has been reported that the SEC and National Student Marketing have reached a proposed settlement of the SEC action. The settlement does not include the other parties defendant. National Student Marketing has agreed to a consent order, without admitting
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*BarChris* and *National Student Marketing* indicate that in the area of securities regulation the central policy of full and accurate disclosure to the investing public imposes a number of obligations upon the attorney who offers an opinion. When those whom he represents seek to disclose information different from that mandated by public policy, it is difficult for the attorney to avoid conflicts of interest. Professor Hazard notes that the most complex duty a lawyer has is that of a fiduciary to third-party interests.\(^{111}\) Considering the *BarChris* decision,\(^{112}\) he asserts that "some kind of duty runs to the 'investing public'. What it is, and how far you have to go in fulfilling it, is problematic."\(^{113}\) Professor Hazard illustrates the problem with the case of *Heyer v. Flaig*,\(^{114}\) where the court stated that the lawyer's duty is dictated by "public policy [which] requires that the attorney exercise his position of trust and superior knowledge responsibly so as not to affect adversely persons whose rights and interests are certain and foreseeable."\(^{115}\)

This duty can be applied to attorneys retained by investment companies, who also have a fiduciary duty to represent the interests of the shareholders of the fund. Thus, information disclosed to the shareholders must be full and accurate. Yet counsel may concurrently represent affiliates of the fund, such as the adviser, whose interests are often not congruent with those of the fund.\(^{116}\) When the interests of the affiliate are clearly in opposition to the fund, counsel's duty to the fund's management and the fund's shareholders is strained to the degree of being incapable of being met.

Another analogy in securities work that might be drawn to the conflicts of interest problems of dual representation arises out of

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111 In commenting on the National Student Marketing action, Professor Hazard has stated that an attorney has four separate bases of obligation when he undertakes to represent a client. These include:

The duty to client, assuming one can define who the client is; the duty to the 'court,' "in this case thinking of the SEC as a court—it is a tribunal that performs quasi-adjudicative processes—it should be, and I think will be, in my judgment, assimilated to a court for the purposes of the attorney's responsibility to a tribunal." The lawyer also has a duty as an agent "under ordinary, simple principles of agency—that is, he is acting in behalf of someone . . . . Finally, and most complexly, he has a duty as a fiduciary to third party interests . . . ."

112 See note 95 *supra*.

113 156 SEC. REG. & L. REP. at A-3 (June 14, 1972).


115 *Id.* at 229, 449 P.2d at 165, 74 Cal. Rptr. at 229.

116 See text accompanying note 16 *supra*. 

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the situation where counsel for the issuer or underwriter, advising the issuer or underwriter on matters pertaining to the registration statement, is also an owner of securities of the registrant. In order to mitigate the resulting conflicts of interest in such a situation, the SEC's Division of Corporation Finance amended the SEC guidelines for the preparation of registration statements to require that counsel who pass upon the legality of the registration or offering disclose in the prospectus the nature and amount of any interest, presently owned or to be received, in the registrant.\textsuperscript{117} Compliance with this directive will enable potential investors to weigh the independence and objectivity of counsel's opinions. It has furthermore been suggested that the remedy of Securities Act Release No. 5094 is insufficient, and that advising attorneys should not be allowed to have any financial interest in the registrant.\textsuperscript{118}

An attorney who holds stock in a registrant has loyalties which are obviously divided. The allegiances of an attorney who is retained by both the investment company and its affiliates are similarly strained, in spite of the fact that his own interests may not be as directly involved. These conflicts are analogous, for in both cases interests which stand in opposition to each other are being represented by one and the same advocate. In a context where conflict of interest situations are easily kindled and duties and obligations are difficult to define, it would seem anomalous to permit counsel to represent both investment companies and their affiliates.

IV. DUTY OF THE DIRECTORS OF INVESTMENT COMPANIES TO RETAIN INDEPENDENT COUNSEL

Several practical factors bear on directors in deciding whether to retain independent counsel. The director himself may not be aware of conflicts of interest, for the attorney will be hesitant to reveal such conflicts if the result is the termination of his services. Retaining additional counsel also increases the costs associated with conducting negotiations and litigation. Where conflicts are not sharply defined these additional costs may seem unjustified. Finally, it may be difficult to implement an operating procedure which can determine when separate counsel is required.

With respect to investment companies, at least four possible

\textsuperscript{117} Securities Act Release No. 5094 (October 21, 1970).
\textsuperscript{118} See SEC Commissioner James Needham's address before the Federal Bar Association, Dec. 2, 1969.
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means could be utilized to select independent counsel. First, it could be required by statute that the fund's disinterested unaffiliated directors retain independent counsel who have no previous connection with the fund's affiliates. Second, it could be required that all insiders such as the adviser, interested affiliated directors, or officers retain separate counsel. Third, present counsel could be required to select new counsel. Finally, the court could select new counsel.

Of these four methods of selection, only the first presents a viable solution to the problem. If the second alternative were chosen there is a good possibility that counsel representing the fund would have a residual bias in favor of their former employers. If the third method were utilized, counsel might select someone whom he felt would not oppose him too vigorously. If the last method were chosen, selection of counsel would be time-consuming. Furthermore, in cases where the court is not familiar with the parties, the selection of proper counsel could be a difficult task. This last method might be used only where a derivative action is brought against the disinterested directors and the officers of the fund. In that event the court could request that the directors submit a list of attorneys from which counsel might be chosen.

The only realistic solution to the problem is that the disinterested unaffiliated directors be required to retain independent counsel to represent the fund. In the case of newly established funds, independent counsel should be retained when the relationships between the fund and its affiliates first come into existence. This would effectively prevent the development of divided loyalties. In the case of already established funds, independent counsel should be required immediately, before conflicts of interest can develop any further.

While disinterested unaffiliated directors have the authority to select and supervise independent counsel, this article contends that these directors have not only a right but a fiduciary duty to

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119 This potential bias would stem from the fact that counsel's first loyalty might remain with the directors and officers who are affiliated with the adviser or underwriter, who have been his principal contact with the "inanimate" corporate client in the past. In addition, counsel might fear that rendering advice antagonistic to the affiliated directors' and officers' interests would impair future relations with his corporate client. See Note, supra note 70, at 533.

120 See id. at 535.

121 In cases where the disinterested unaffiliated directors hire counsel to represent the fund, counsel should be paid by the fund and not the adviser. See text accompanying notes 36-40 supra.

122 See parts I B and C supra.
the fund under Subsection 36(a) of the Investment Company Act to demand the retention of independent counsel.\footnote{Pursuant to the common law of corporations, directors owe a fiduciary duty to the corporation and its minority shareholders to act in the best interests of the corporation. They cannot use their position of trust to benefit themselves or a particular group of shareholders at the expense of the corporation or its other shareholders. He who is in such a fiduciary position cannot serve himself first and his \textit{cestuis} second \ldots. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. \textit{Pepper v. Litton}, 308 U.S. 295, 311 (1939). In addition, a director owes loyalty and allegiance to the company—a loyalty that is undivided and an allegiance that is influenced in action by no consideration other than the welfare of the corporation. Any adverse interest of a director will be subjected to a scrutiny rigid and uncompromising \ldots. \textit{Litwin v. Allen}, 25 N.Y.S.2d 667, 677 (Sup. Ct. 1940). \textit{See generally Comment, Private Rights of Action Against Mutual Fund Investment Advisers: Amended Section 36 of the 1940 Act}, 120 U. Pa. L. Rev. 143 (1971); \textit{Freedman \& Rosenblatt, Duties to Mutual Funds}, 4 Rev. Sec. Reg. 937 (1971); \textit{Vanderwicken, Change Invades the Boardroom}, \textit{Fortune}, May, 1972, at 156.} \footnote{Section 1(b) provides in part: \begin{quote} \textit{[I]}t is declared that the national public interest and the interests of investors are adversely affected—\ldots \end{quote} \begin{quote} (2) when investment companies are organized, operated, managed, or portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interests of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders \ldots. \end{quote}}

\textbf{A. Statutory Authority for the Retention of Independent Counsel}

The express policy of the Act provides a useful starting point for a discussion of the statutory authority for requiring the disinterested unaffiliated directors of investment companies to retain separate counsel. Subsection (b)(2) of Section 1 states that the national interest is adversely affected when investment companies are operated for individual interests rather than those of the entity as a whole.\footnote{15 U.S.C. § 80a-1(b) (1970).} Arguably, those conflicts of interest which arise out of the retention of the same counsel by investment companies and their affiliates adversely affect the national public interest and the interests of shareholders, for this dual representation evidences that these investment companies are being operated for the benefit of their affiliates and not the interests of their shareholders.

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That subsection authorizes the SEC to bring an action alleging that an officer, director, or adviser of a registered investment company has engaged in or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct with respect to the company.125 When the fund becomes involved in a controversy with any of its affiliates, the disinterested unaffiliated directors of the investment company may have a fiduciary duty to the fund shareholders to secure independent counsel to represent the fund; if so, the failure to do so would be punishable under Subsection 36(a).

Various sections of the Act prohibit investment company management from engaging in certain types of conduct. The complexity of the investment company industry and the unique relationships upon which it rests, however, present possibilities for abuses which were not readily anticipated when the statute was first enacted. It was therefore necessary to insert a residuary clause into the Act which would encompass unspecified conduct involving a breach of fiduciary duty on the part of the fund's affiliates. This catchall clause was Section 36.126 It had been suggested that the fund's independent directors should be held to a higher standard of fiduciary duty under Section 36 than the affiliated directors of the adviser.127 Subsection 36(a), as previously noted,128 was amended by Congress in 1970. Prior to that time, the SEC had been empowered to take action only in situations where the investment company management had engaged in conduct amounting to a "gross abuse of trust." Currently any breach of fiduciary duty involving personal misconduct will permit the SEC to bring an action. The fiduciary standard required has been made more encompassing.129 A strong argument can be

125 Id. § 80a-35(a). See also text accompanying note 41 supra.
126 Note, supra note 7, at 937.
127 See id. at 939. See also Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y. 1961), aff'd, 294 F.2d 415 (2d Cir. 1961); Comment, supra note 5, at 707.
128 See text accompanying note 41 supra.
129 Id. According to the House Report on the bill to amend Section 36,

The amended section will enable the Commission to move against officers, directors, and advisory board members of an investment company and its investment advisers or principal underwriters if they engage or are about to engage in conduct which violates prevailing standards of fiduciary duty involving personal misconduct.

... [Section 36 was] not intended to provide a basis for the Commission to undertake a general revision of the practices or structures of the investment company industry. On the other hand, [it was not intended] to limit the Commission under this section to situations where an actual intent to violate the law can be shown or to acts of affirmative misconduct. In appropriate cases, nonfeasance of duty or abduction [sic] of responsibility would constitute a breach of fiduciary duty involving personal misconduct. H.R. REP. No. 91-1382, 91st Cong., 2d Sess. 37 (1970) (emphasis added).
made that the failure on the part of the directors of an investment company to retain separate counsel when conflicts of interest arise between the investment company and its affiliates should be deemed nonfeasance of duty or abdication of responsibility on the part of these directors (especially the disinterested unaffiliated directors) and therefore a violation of Subsection 36(a) of the Act.

B. Recent Decisions—Duty of Directors and Affiliated Persons

Several noteworthy cases decided recently emphasize the fiduciary responsibilities of affiliates of investment companies and indicate increasing public awareness of the issues surrounding fiduciary obligations.130 Moses v. Burgin 131 was a derivative action by shareholders of Fidelity Fund. The plaintiffs alleged violations of the Act arising out of Fidelity's use of "reciprocals" (the practice of placing commission business with broker-dealers who sold Fidelity shares or provided research) and "give-ups" (the practice of directing other brokers to "give up" a portion of their commissions on Fidelity business to broker-dealers who sold Fidelity shares or provided research). The shareholders charged that these practices benefited the adviser and not the fund. The shareholders further alleged that Fidelity should have "recaptured"132 a portion of the brokerage commissions or used alternative methods which would increase benefits to the Fidelity shareholders by a reduction in the advisory fee.133 The attack on this use of reciprocals was unsuccessful. The court of appeals did note, however, that for the management of an investment company "[s]elf-dealing is not the exception but... the order of the day."134 The court stated that in response to this self-dealing Congress had enacted a mandatory provision for independent "watch-dog" directors. The

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130 See Investment Company Institute v. Camp, 274 F. Supp. 624 (D.D.C. 1967) in which the court stated that the board of directors of mutual funds "have essentially the equivalent powers as any corporate board of directors..." and as such are "also responsible to their shareholders as fiduciaries." 274 F. Supp. at 630. See also Pepper v. Litton, 308 U.S. 295, (1939); Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y. 1961), aff'd, 294 F.2d 214 (2d Cir. 1961).


132 Recapture arrangements usually provide for the institution to set up a broker-dealer affiliate as a member of a regional exchange for the purpose of effecting brokerage transactions and then applying the commissions on these transactions against the fund's advisory fee.


134 445 F.2d at 376.
conflict thought that management had a legal duty to these independent directors to inform them of the possibilities of recapture. In concealing the information management had violated that duty. The court defined the standard of disclosure owed to these independent directors:

Whatever may be the duty of disclosure owed to ordinary corporate directors, we think the conclusion unavoidable that Management defendants were under a duty of full disclosure of information to these unaffiliated directors in every area where there was a possible conflict of interest between their interests and the interests of the fund.

The court found that the management defendants knew that the possibility of recapture was a serious and unresolved issue involving a potential conflict between the interests of management and of the shareholders. Their failure to bring this possibility to the attention of the independent directors constituted gross misconduct and was therefore a violation of the former Section 36 of the Act.

This decision reinforces the concept of the disinterested director as one whose function is to represent objectively the interests of fund shareholders. The affiliated directors had a duty of disclosure to the disinterested directors. It was therefore a breach of fiduciary duty not to disclose the possibility of recapture. The court stated that disinterested directors have a duty to act on the information disclosed and any nonfeasance on their part is also a breach of fiduciary duty.

The duty to disclose is not the only case illustrative of possible conflict of interest situations. In April, 1972, the breakpoint on negotiated rates for commissions on the trading of securities was lowered to $300,000. As a result, investment companies who have management companies with an affiliate on a regional exchange are permitted to negotiate commissions on all transactions.

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135 Once disclosure was made it would then be for the board of directors to determine according to their best business judgment if recapture were feasible. The business judgment rule is a defense for directors who, in the exercise of their discretionary powers, cause corporate losses through errors in judgment. It is founded on the belief that directors, elected by the shareholders for this purpose, are in the best position to decide corporate policy and that a court, less familiar with the problems involved, should not substitute its judgment for that of the directors. The shareholders have no right to appeal to the courts for relief from the decisions made by the directors if these decisions are made in good faith, with due care, and in accordance with applicable fiduciary duties owed the corporation and its shareholders.

136 445 F.2d at 376 (emphasis added).

137 Id.at 384.


139 See Comment, supra note 2, at 43 l–33.
over that figure. Subsection 17(e) of the Act states that these affiliates are permitted to charge a reasonable and customary commission rate. In light of this authority the question emerges as to how affiliates can negotiate a commission rate with themselves. It should be evident that with so many conflicts of interest the retention of the same attorney by the fund and its affiliates exacerbates an already difficult situation.

In *Rosenfeld v. Black* the Court of Appeals for the Second Circuit stated that an investment adviser is a fiduciary and thus comes within the scope of the principle that a fiduciary may not sell or transfer his office for personal gain. The case involved the sale by Lazard Freres, the Lazard Fund's adviser, of the advisory agreement at a substantial profit. The court stated that when Congress required that the shareholders approve any new advisory agreement in Subsection 15(a) of the Act, it must have meant an approval uninfluenced by any improper motivations on the part of the outgoing adviser. The court also believed that the very fact of nonassignability of an investment contract demonstrated that any payment made to the 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. In his analysis of the transaction, Judge Friendly started from the basic common-law principle that because of inherent conflicts of interest, a trustee may not traffic in his trust. He then reasoned, "The only certain way to insure full compliance with that duty is to eliminate any possibility of personal gain." The court thought that it was implicit that these basic common-law principles of equity were specifically incorporated into the Act.

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140 15 U.S.C. § 80a-17(e)(2) (1970) states:

> It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person—

> (2) acting as broker, in connection with the sale of securities to or by such registered company or any controlled company thereof, to receive from any source a commission, fee, or other remuneration for effecting such transaction which exceeds (A) the usual and customary broker's commission if the sale is effected on a securities exchange.


142 15 U.S.C. § 80a-15(a)(4) (1970) provides that an investment advisory contract will automatically terminate in the event of its assignment, stating that an assignment:

> includes any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor.

143 445 F.2d at 1342.

144 Id. at 1345.
The Rosenfeld case underscores and emphasizes to investment advisers that they stand in a fiduciary position with respect to the investment companies they advise. Furthermore, while the new amendments to Section 36 of the Act expressly make the investment adviser a fiduciary with respect to the receipt of compensation from the investment company, Judge Friendly thought that it was plain that Congress did not intend this section to be the exclusive fiduciary duty of investment advisers.

The failure on the part of the investment adviser in Rosenfeld to live up to the fiduciary standard owed to the fund shareholders is analogous to a situation where the independent directors of the fund fail to obtain independent counsel and instead permit the same counsel to represent both the fund and the adviser in any litigation. The analogy is based on the reasoning that this failure is a breach of fiduciary obligation. At the very least, just as the adviser should have disclosed to the Lazard Fund shareholders any profits that were made on the sale of the advisory agreement, the directors of a fund should be required to disclose that the same counsel is attempting to represent the interests of both the fund and the adviser in litigation. In the final analysis disclosure alone may not be sufficient to satisfy the directors' fiduciary responsibilities to the fund; the hiring of independent counsel should be required where the interests of the investment company and its affiliates are clearly adverse.

Escott v. BarChris Construction Co. is pertinent here, although that case was concerned with the directors and affiliates of an operating company. The court noted that a director is presumed to know his responsibility to the shareholders of the corporation when he becomes a director. The court further stated that "[a director should] not act in an important matter without


\[T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser . . . .

\*146 445 F.2d at 1348. The Rosenfeld decision was directly responsible for the recent legislative proposal of the SEC to Congress that is designed to permit investment advisory companies to sell their businesses at a profit under certain circumstances. Commissioner Sydney Herlong, Jr., stated that the confusion created by the Rosenfeld decision with respect to whether a premium can be paid for a management company is "undesirable." Under the proposed legislation, a proposed new adviser would not be assured, however, of having its management contract approved by the fund. N.Y. Times, May 19, 1972, at 49, col. 4.

\*147 See text accompanying notes 128–29 supra.


\*149 283 F. Supp. at 688.
any knowledge of the relevant facts, in sole reliance upon the representations of [others]. . . ." The court applied this standard to both the internal directors and those not associated with the internal management of the corporation.

Although the responsibilities discussed above are in the context of those owed when investigating registration statements, the same reasoning can be applied to directors of investment companies in all of their duties. In investment companies, the disinterested unaffiliated directors serve an important function as a buffer between the fund shareholders on one side and the affiliated directors and adviser on the other. Disinterested directors should not uncritically approve matters which call for their approval simply because the position is supported by the affiliated directors or adviser. Arguably the disinterested unaffiliated directors have a fiduciary obligation to exercise their best business judgment and to recommend that the fund retain independent counsel when the fund's interests are in conflict with those of its affiliates. In light of BarChris it can be argued that the disinterested unaffiliated directors should be held to a higher standard of fiduciary duty under Section 36 of the Act than the affiliated directors or the adviser. In BarChris the public might have looked to the professionals to assure accurate preparation of the registration statement. With the investment company and its complement of interested managers, the public's interest is more properly identified with the unaffiliated directors. If this were sufficient to raise the duty of reasonable investigation in BarChris it should also be sufficient to raise the duty of the nonaffiliate under Section 36. Retention of separate counsel by the disinterested unaffiliated directors would significantly implement the effectuation of these duties.

C. A Useful Comparison: Chapter X of the Bankruptcy Act

The suggestion that the directors of an investment company have a fiduciary responsibility to retain independent counsel to represent the interests of the fund should not be considered a startling revelation. What is startling is that the hue and cry has

150 Id. Judge McLean noted that "[the positions of the underwriter and the company's officers are adverse . . . ." and it is the underwriter's duty to delve deeply and independently into the company's fiscal position. Id. at 696-97.
151 See text accompanying note 26 supra.
152 See note 135 supra.
153 See Note, supra note 3, at 939.
not been sounded sooner. For years attorneys appointed to represent a Chapter X trustee have been required to be disinterested persons. A trustee under Chapter X has the primary responsibility for the effectuation of a plan of reorganization. Success of the reorganization largely depends upon the fashion in which he performs his duty. Success is also largely a function of the trustee's attorney.

Chapter X of the Bankruptcy Act requires that the trustee's attorney be as disinterested as the trustee himself. The logic is simple: it would be anomalous to require that the trustee be disinterested and at the same time permit him to be guided and directed in his duties by an attorney who is not disinterested. This necessarily follows because the trustee's lawyer is "a controlling and conditioning force in the entire reorganization system." The same reasoning applies to the investment company industry. It would be senseless for a mutual fund and its disinterested unaffiliated directors to be represented by an attorney who is not completely disinterested in the fund's adviser or underwriter. Only if the attorney is chosen by the disinterested directors and paid by the fund, not by the adviser, can the public shareholders' interests best be represented.

In the case of In re G. W. Giannini, Inc., the court expounded upon the rule calling for independent counsel in bankruptcy proceedings. It held that disinterested counsel must be required in order to prevent not only actual evils in specific cases but "the tendency to evil in all cases." It has been stated that

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A person shall not be deemed disinterested, for the purposes of [the Act], if

(3) he is, or was within two years prior to the date of the filing of the petition, an attorney for the debtor or such underwriter, (emphasis added).


156 See In re McGrath Mfg. Co., 95 F. Supp. 825, 834 (D. Neb. 1951); see also 6 COLLIER ON BANKRUPTCY § 7.06 at 1175 (14th ed. 1971).


158 When counsel represents both the fund and its affiliates, problems are likely to arise. In the course of the proceedings counsel will necessarily appear as an adversary to many participants. Even if counsel has taken his position with the strictest impartiality, disappointed litigants may suspect the worst and may be inclined to attribute his actions, however baselessly, to his concern for other clients. The resulting atmosphere is almost impossible to cope with, and can even affect the reputation of counsel as well as the client's faith in the proceeding.

159 90 F.2d 445 (2d Cir. 1937).

160 Id. at 448.
this rule will have no exceptions, even where it can be shown that counsel acted in good faith.¹⁶¹

V. MEANS OF REFORM: SEC RULEMAKING

The problem of the retention of independent legal counsel can be seen from two points of view. One view embodies the notion that there is an ethical obligation for attorneys to refrain from representing clients in situations where conflicts of interest may or could possibly exist. The American Bar Association has formulated general rules of conduct which attempt to deal with conflicts resulting from dual representation.¹⁶² The ABA explicitly stated in its former Canons of Professional Ethics that no code or set of rules can be promulgated which will specify all the duties of the lawyer.¹⁶³ The Canons also stated that they are intended as a general guide and not meant to deny the existence of other more specific rules.¹⁶⁴ It is reasonable to assume that these concepts apply to the new Code as well.¹⁶⁵ The cases discussed in this article demonstrate that although the ABA attempts to regulate the conduct of lawyers, its efforts have not always met with success.¹⁶⁶ Enforcement of these guidelines with respect to the investment company industry has been negligible. The resolution of the problem of conflicts of interest resulting from dual retention of lawyers by investment companies and their affiliates can be found in the fiduciary obligation of directors and officers of investment companies to prevent conflicts of interest. In conjunction with this, it is the responsibility of the SEC to create an atmosphere that is conducive to the recognition of these fiduciary obligations. Although Congress itself might consider resolving this conflict of interest problem by statutory amendment, the exercise by the SEC of its rulemaking power would appear to be the most effective means available.

¹⁶¹ See In re Progress Lektro Shave Corp., 117 F.2d 602, 604 (2d Cir. 1941) where an attorney was denied compensation for his services because he was not disinterested. The SEC has stated that it

customarily examines the qualifications of trustees in the light of the standards of disinterestedness prescribed by the statute for trustees and their counsel. Where it appears that the trustee or his counsel is not disinterested, the Commission calls the facts to the attention of the court and takes other appropriate steps looking toward the resignation or removal of those

fiduciaries.

SEC, 18TH ANN. REP. 144 (1952).

¹⁶² See text accompanying note 44 supra.

¹⁶³ ABA CANONS OF PROFESSIONAL ETHICS, PREAMBLE.

¹⁶⁴ Id.

¹⁶⁵ See note 44 and accompanying text supra.

¹⁶⁶ See text accompanying notes 95–115 supra.
Conflicts of Interest

One realistic and feasible solution would consist of a two-stage approach. The SEC might first issue an informative release which would delineate the problem and indicate to directors and officers of investment companies, especially the disinterested unaffiliated directors, that under Subsection 36(a) of the Act and applicable case law, they have a fiduciary duty to the shareholders of their respective funds to prevent conflicts of interest resulting from the retention of the same attorneys by both investment companies and their affiliates. This release would instruct directors and officers that in order to avoid these conflicts investment companies should retain separate counsel. Although the release would not promulgate direct punitive sanctions for failure to comply with its suggestions, it nevertheless would clarify this aspect of the obligations owed by directors and officers of investment companies to fund shareholders.

The SEC might thereafter allow an adequate period for the investment company industry to comply with the SEC's suggestions. During this time the SEC could determine the extent to which there has been compliance with the release. If a significant number of funds comply, the Commission might then require that any noncomplying fund disclose to its shareholders that both the fund and its affiliates employ the same counsel, that possible conflicts of interest may thereby result, and that the Commission has requested that this practice cease. The SEC could implement these disclosure requirements by amending its guidelines for the preparation of registration statements. These proposed disclosure requirements would subject the directors and officers of noncomplying funds to action brought either by the SEC or by shareholders pursuant to Subsection 36(a) of the Act.

If after the original period, however, the Commission determines that a substantial number of funds have failed to retain separate counsel, it could then promulgate a rule affirmatively requiring that mutual funds retain separate counsel. Because of the additional administrative burden entailed, this approach would be more difficult to implement than a noncompulsory directive. Yet

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167 This should allow sufficient time for funds to secure new counsel and allow their present attorneys to complete or transfer pending matters.
169 Id. § 80a-35(a). See Freedman & Rosenblatt, Duties to Mutual Funds, 4 Rev. Sec. Reg. 937 (1971); Comment, supra note 5, at 700.
in all likelihood, the mandatory approach would prove more effective.

Subsections 36(a)\textsuperscript{170} and 38(a)\textsuperscript{171} of the Act grant the SEC the authority by which it could promulgate a rule governing the employment of separate counsel. The rule might state that for purposes of Subsection 36(a) a breach of fiduciary duty on the part of a fund's officers and directors \textit{may result} from the retention by the fund and its affiliates of the same counsel. The SEC should adopt the position that not all cases in which the fund and its affiliates retain the same attorney result in conflicts of interest leading to a breach of fiduciary duty. A proposed rule should simply state that retention of the same counsel in these circumstances \textit{may} bring about conflicts of interest which would be violative of Subsection 36(a).

The authority of the SEC to promulgate rules such as the one proposed here is broad in scope.\textsuperscript{172} The rules of the Commission may be generally classified as either exemptive or nonexemptive in character. Exemptive rules permit those who fall within the Commission's statutory jurisdiction to engage in conduct which would normally be proscribed by the Act. To allow the Commission to exempt conditionally or unconditionally any person, security, or transaction from any of the provisions of the Act, Subsection 6(c)\textsuperscript{173} grants the SEC extensive power to promulgate exemptive rules.\textsuperscript{174} The only limitation on these exemptive powers is that a rule exempting a specific course of conduct or transaction must be "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act.\textsuperscript{175} Nonexemptive rules, on the other hand, aid in effectuating the legislative intent of particular sections of the Act. Subsection 38(a) gives the Commission authority to promulgate nonexemptive rules in cases where a particular section of the Act does not specifically confer this authority.\textsuperscript{176}

\begin{itemize}
  \item \textsuperscript{171} 15 U.S.C. § 80a-37(a) (1970).
  \item \textsuperscript{172} See Motley et al., supra note 17, at 451; Jaretzki, supra note 17, at 344.
  \item \textsuperscript{173} 15 U.S.C. § 80a-6(c) (1970).
  \item \textsuperscript{174} Jaretzki, supra note 17, at 344.
  \item \textsuperscript{175} 15 U.S.C. § 80a-6(c) (1970).
  \item \textsuperscript{176} On numerous occasions the SEC has used this broad grant of authority to promulgate rules exempting conduct which would otherwise be prohibited by other sections of the Act. It is worth noting that the language of some sections specifically confers rulemaking power on the Commission while other sections are silent in this regard. Subsection 6(c) has been used by the SEC to promulgate rules under various sections of the Act regardless of whether specific rulemaking authority has been conferred by other sections.
  \item \textsuperscript{177} Section 38(a), 15 U.S.C. § 80a-37(a) (1970), provides in part:
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The legislative history of the Act reveals that the rulemaking authority vested in the Commission by Subsection 38(a) was intended to conform with the general rulemaking powers of similar provisions in the other federal securities laws. Although the specific wording of the subsection grants the SEC authority to make rules "as are necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in this title," the legislative history of the 1970 amendments indicates that the statutory wording should be interpreted as being synonymous with the wording of Subsection 20(a) of the Public Utilities Holding Company Act of 1935 (PUHC Act). The wording of Subsection 20(a) of the PUHC Act states that the Commission has rulemaking authority "as it may deem necessary or appropriate to carry out the provisions of this title." The interpretation given to this language is crucial in determining whether the Commission can promulgate rules under Subsection 36(a) of the Act, for the wording of Subsection 36(a), although authorizing actions based on breaches of fiduciary duty, does not confer specific rulemaking authority on the Commission. If Subsection 38(a) is interpreted

The Commission shall have authority ... to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in this subchapter, including rules and regulations defining accounting, technical, and trade terms used in this subchapter.... For the purposes of its rules or regulations the Commission may classify persons, securities, and other matters within its jurisdiction and prescribe different requirements for different classes of persons, securities, or matters.

177 See Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., pt. 1, at 310, 312-317 (1940). The other sections are § 19(a) of the Securities Act of 1933, 15 U.S.C. § 77s(a) (1970), § 23(a) of the Securities Exchange Act of 1934, id. § 78w(a), and § 20(a) of the Public Utility Holding Company Act, id. § 79t.

178 15 U.S.C. § 79t (1970). See Hearings on H.R. 9510, 9511 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 90th Cong., 1st Sess., pt. 1, at 15, 86 (1967) in which the Commission and the Investment Company Institute agree that existing provisions of the... Act give the Commission rule-making authority which is comparable to that provided under other federal securities laws and that the difference in language among the various rule-making provisions are not intended to indicate substantive differences in the extent of such authority. Accordingly, if the Congress agrees with this conclusion, Section 21 of S. 1659 would serve no useful purpose and should be deleted from S. 1659. Id. at 86. Congress agreed with this conclusion by dropping the proposed amendment of § 38(a). The amendment would have read, in pertinent part:

The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as it may deem necessary or appropriate to carry out the provisions of this title ....

Id. at 15 (emphasis added).

179 It should be emphasized that the Commission has, in the past, promulgated rules pursuant to the authority vested under § 38(a) where the specific wording of a section did not confer rulemaking authority.
to be equivalent to Subsection 20(a) of the PUHC Act, then all that need be demonstrated in order to promulgate a rule under Subsection 36(a) is that the rule is necessary or appropriate to carry out the provisions of the Act. That is to say, it is not necessary to demonstrate that a specific power is conferred upon the SEC by the statutory wording of Subsection 36(a). Arguably, just as Subsection 6(c) has been used by the Commission to promulgate exemptive rules under sections which contain no specific language granting rulemaking authority, Subsection 38(a) can be used by the Commission as the authority for issuing a nonexemptive rule under Subsection 36(a).

Once it has been established that the SEC has rulemaking authority under Subsection 36(a), the critical question becomes whether the specific rule to be adopted comes within the statutory requirement that it be "necessary or appropriate to carry out the provisions" of the Act. Both the disjunctive phraseology and the legislative history of Subsection 38(a) indicate that a rule does not have to be "necessary" to carry out the provisions of the Act but is supported by statutory authority if it is merely "appropriate" to carry out such provisions.\textsuperscript{180} Subsection 36(a) gives the SEC express power to institute legal actions for breach of fiduciary duty. Subsection 38(a) gives the SEC power to make rules necessary or appropriate to the exercise of that express grant of power. The rule proposed here would define a breach of fiduciary duty on the part of a fund's directors and officers to include those situations where the fund and its affiliates retain the same attorney. The power to define breach of fiduciary duty for purposes of Subsection 36(a) would be an "appropriate" means of enabling the Commission to determine whether to bring suit.

This proposed rule would not deprive the courts of an issue upon which to rule. A court would still determine whether the facts involved in a particular case in which both the fund and its affiliates retain the same attorney resulted in a conflict of interest. Having so determined, a court would then be free to decide whether the officers and directors breached their fiduciary duty to fund shareholders by permitting this situation to exist. If a breach were found, liability would follow under Subsection 36(a). Rather than abrogating the authority of the courts, this proposed rule would serve to bring situations which may be violative of Subsec-

\textsuperscript{180} The word "appropriate," which did not appear in the Securities Act of 1933 or the Securities Exchange Act of 1934 was contained in § 20(a) of the PUHC Act and was also incorporated into the wording of the initial bill on investment company legislation. A study of the legislative history indicates that a rule which is only "appropriate" and not "necessary" is nevertheless authorized if otherwise satisfactory.
tion 36(a) to the attention of the court so that an outcome with full judicial authority will ensue. The Commission would initiate the legal proceedings while the courts would determine whether an actual breach of duty has occurred. 181

Subsection 38(a) provides a further source of statutory authority for the proposed rule. That subsection provides that the Commission shall have rulemaking authority as long as the rules it promulgates "are necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in this subchapter, including rules and regulations defining accounting, technical, and trade terms used in this subchapter . . . ."182 The use of the word "including" can have two possible meanings in this context. On one hand, it can be narrowly construed so that the scope of the Commission's rulemaking authority under the section is limited to defining accounting, technical, and trade terms used in the Act. If this is the accepted interpretation, the SEC has authority to promulgate the rule proposed here because the term "breach of fiduciary duty" as used in Subsection 36(a) is a technical term subject to definition under Subsection 38(a). On the other hand, if the word "including" is construed broadly, it can be argued that the statutory wording is intended merely to set forth examples of areas subject to SEC rulemaking authority. The Commission has the authority to promulgate rules in other areas so long as these rules are "necessary or appropriate" to the exercise of the powers conferred upon the Commission in other sections of the Act. If this latter interpretation is accepted then the Commission would simply have to demonstrate that a rule is necessary or appropriate to carry out the provisions of the Act. In light of either interpretation, there would appear to be no obstacles remaining which prevent the SEC from promulgating the rule proposed in this article.

VII. CONCLUSION

This article has considered the legal implications of the same attorney's representing both an investment company and its affiliates. 183 The practice is currently widespread, and, as has been

181 See note 41 supra. The Commission apparently feels that it can determine in its own right whether a breach of fiduciary duty has occurred.


183 Although the scope of this article has been limited to attorneys' conflicts of interest in the investment company context, similar problems arise when a fund and one or more of its affiliates employ the same accountants. See generally Kripke, The SEC, the Accountants: Some Myths and Some Realities, 45 N.Y.U.L. REV. 1151 (1970); Higgins, Professional Ethics: A Time for Reappraisal, J. ACCOUNTANCY, Mar., 1962, at 29.
shown, is in many cases detrimental to the interests of the mutual fund and its shareholders. This article has argued that under traditional notions of corporation law the directors of an investment company may have a fiduciary duty to retain counsel independent of the counsel retained by the adviser of the fund; additionally, an attorney may have a corresponding ethical duty not to represent both the adviser and the fund. However, because practical forces bear on both the investment company and the attorney not to insist that the fund retain independent counsel, government regulation of the relationships between the fund, its affiliate, and counsel is appropriate. To this end, this article has suggested an approach that the SEC might adopt to protect the currently unprotected interests of mutual fund shareholders. Although other means of achieving this goal are possible, the current structure of the investment company industry dictates that the most efficient means of affording needed protection to shareholders is affirmative action by the SEC of the type proposed in this article.