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Remarks to
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Course of Study on Broker-Dealer Regulation
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"The Conservative Regulator as Adventurer"

Stephen J. Friedman, Commissioner

A few weeks ago, I suggested that there was a critical need to start thinking in new ways about the structure of financial regulation in this country. There has been a dramatic merging of function among the traditional financial institutions -- banks, securities firms and investment companies, and although we continue to regulate them in different ways, what they do grows more similar by the month. I was not suggesting that we simply throw up our hands and permit every financial institution to do everything and lodge oversight in one agency, but rather that it is terribly important to look at events with clear eyes, avoiding the special purpose prisms of the traditional regulatory framework. Those prisms bend the light and what we see falls into expected patterns. But what is there does not.

The problem -- of the effect of institutional change upon regulatory matters -- is one that is also found in the classic areas of Commission concern, such as regulation of broker-dealers. And its existence has important and interesting implications for the appropriate role of the regulator.

There is great appeal in the proposition that a regulatory system, once established, should be administered in a conservative manner, that regulators should not be constantly re-inventing the wheel and searching for new conduct to regulate. Change should flow from a demonstrated need. That approach characterizes the deregulation of commission rates, for example, which did not finally take place until the evidence of break-down in the established regulatory system was all around us. The beauty of that approach is not that it makes a virtue of indecision. It also recognizes the real uncertainty about the full effect of the consequences that attend any important change in the economic ground rules.

Against that portrait of conservative and responsible behavior, the SEC's constant tinkering with the system, the flow of new rules and of changed rules, and the conceptual elaboration that occasionally approaches the rococo, strikes some observers as regulatory adventurism. We hear complaints from companies, broker-dealers and investment companies that new rules are proposed before the old ones are digested.

Nevertheless, I think that a regulator which clings to concepts that no longer correspond to the world for which they were designed is not acting conservatively, merely blindly. I have a favorite story about the Japanese artist Katsushika Hokusai, who died in 1849. He was wildly prolific, and produced more than 13,000 prints and drawings. As he lay dying at the age of 90, his daughter heard him murmur: "If I could only have just five more years I could become a really great painter."

The same wistful feeling inhabits the souls of financial regulators: "In a year or two the regulatory system will be just right -- if only the financial markets would stand still for a while."

But the markets do not stand still. And if the regulatory system stands still, at best it may become irrelevant. At worst, it may interfere with competition, inhibit evolution and prevent adaptation. We exist to help maintain the efficiency, stability and fairness of the markets. Regulatory action that cannot meet that standard has no justification.

Thus, in a curious way, it is not really possible to maintain the status quo through inaction. The rate and degree of change in the financial markets forces on us a constant process of self-examination -- and upon you a constant burden of contributing to that process. The increasing application of *ex parte* concepts developed in the context of adjudicatory and formal rule-making proceedings to informal rule-making proceedings, has made the communications process rigid and formal. It has limited our ability and that of the staff to talk directly to affected groups about proposed rules.

I think it is the confluence of these two factors: the rapidity of change in the marketplace -- which gives rise to the need for constant re-examination -- and the requirement of a relatively formal communication process, that has produced the constant stream of concept releases, proposed rules and requests for comments.

I would like to test that hypothesis, or at least the first part of it, by briefly examining three matters at the core of our traditional concerns and one to which we have devoted relatively little time:

1) inflation accounting,

2) the net capital rule,

3) the suitability concept, and

4) patterns of compensating registered representatives.

Inflation Accounting

I begin with inflation accounting, although it is not directly related to broker dealers. Nevertheless, it strikes me as the prototypical example of the beguiling dangers of

inaction. There are few conceptual systems as comprehensive, elaborate and detailed as historical cost accounting. It is a monument to the human need to impose order on the chaos of reality. With all its limitations, the system has basic internal consistency and within its parameters, it works pretty well.

The inflationary experiences of the last decade are not within these parameters. The Commission has responded with what some regard as a misadventure into reserve recognition accounting and accounting for the effects of changing prices. The current manifestation of the latter, of course, is the experiment known as Statement 33 of the FASB. I would like to put aside for a moment the merits of those particular proposals and ask you to consider whether we should have done nothing at all in this area.

Price Waterhouse recently analyzed the Statement 33 data of a group of industrial companies and concluded that real corporate income is only 60% of the reported amount, and probably less. The inflation-adjusted return on assets of the group shrunk from 17% in nominal dollars to 8%.

That state of affairs presents alarming opportunities for self-delusion -- on the part of investors, management and policy-makers. For example, it was widely believed that corporations are taxed at an effective corporate tax rate of 39 percent. In fact, inflation accounting methods reveal that the composite of industrial corporations pay a significantly higher real tax rate of 53 percent. Similarly, the general assumption, using historic cost accounting, had been that cash dividend payments on common stock are about one-third of corporate aftertax income, when in reality they are double -- two-thirds of inflation-adjusted income after taxes. Harold Williams has recently pointed out that the aggregate of those composite figures for taxes and dividends paid on an inflation-adjusted basis approaches -- and in some industries exceeds -- corporate income. That suggests that portions of the industrial sector must be paying their taxes and dividends out of capital resources.

In my judgment, that puts the difficulties of inflation-adjusted accounting in an entirely different light. The issue becomes not "whether," but "how." The question of whether to take some step has been answered by events.

<u>The Net Capital Rule</u>

With that example before us, let me turn to the net capital rule. Again, we have a highly complex and elaborate conceptual system -- arcane to the outside observer -- of time-honored

lineage. Its last major revision was as recent as 1975. Moreover, the rule appears to have been working effectively. Indeed, it may be too protective. The SIA has suggested that the rule hampers growth in ways that are not related to its objectives.

The primary purpose of our capital requirements is customer protection. A broker-dealer is highly dependent on liquid assets, perhaps more so than any other financial institution. The net capital rule is designed to insure that firms have sufficient liquidity to meet their commitments to customers -- to satisfy current claims for cash and securities promptly. The net capital rule also provides assurance to other members of the broker-dealer community that a broker-dealer will be able to meet its obligations.

Now, what is the significance of the proliferation of financial instruments -- for example, options, forwards, repurchase agreements, financial futures and commercial paper -- of the growth of government securities activities and of the general diversification of securities firms? When the net capital rule assumed its current form in 1975, it was revised to take into account the development of new instruments and to deal with the new assets and liabilities that were appearing on broker-dealer balance sheets. Is that enough?

For a variety of reasons, some firms have begun to place their nontraditional securities activities in separate corporate pockets in the holding company structure. One could conclude, of course, that the isolation of broker-dealer activities in a corporation subject to the net capital rule is enough to protect the firm's securities customers, which are the only customers for which we have full regulatory responsibility; and that so long as there are adequate liquid assets to pay those claims as they fall due, our duty has been discharged. After all, the proponents of this view argue, the alternative is to regulate the non-regulated activities, which is not within the SEC's mandate.

Before making that judgment, however, I think there are some questions we must answer. Insofar as securities activities are concerned, the net capital rule provides stability as well as customer protection. It does not, of course, insure against bad business judgments or the adverse effects of bad markets. But, at least in theory, it brings close regulatory supervision when a firm begins to experience real financial problems, and requires a cessation of operations at a point when all or most of the customers' claims should be covered by liquid assets. To the extent that government securities activities, or trading in the Ginnie Mae forward market, are conducted by a broker-dealer, the net capital

rule functions in the same way for those activities. But if they are carried on by another subsidiary of the holding company, the net capital rule has no application. The effect of that rule on the stability of those other operations is lost.

Notice that the rule has not changed. Indeed, it was improved in 1975. But the facts have changed, and the assumptions that underlay the decision to adopt the rule may no longer be applicable. The theory of insulating the broker-dealer operations in a corporate subsidiary works fine when there is relatively little from which to insulate them. But it is excessively utopian to believe that the bankruptcy of a sister corporation is not an event of great, or even mortal, moment for the broker-dealer. My point is simply that while nothing may have happened to the functioning of the net capital rule, it may be equally the case that the assumptions which made that rule a sufficient response to concerns about broker-dealer stability are no longer tenable. I do not know the answer to that question. But I suspect that the Commission inevitably will be drawn into the very difficult business of thinking further about the implications of non-securities activities of broker-dealer holding companies.

Suitability Rules

The obligation of a securities salesman or counselor to deal fairly with his client is an essential element in maintaining investor confidence. It was born in the conventional wisdom that securities are sold to individual investors, not bought, and in a well constructed regulatory system that obligation should extend widely. Yet the current department store of financial instruments and services has produced seemingly anomalous results in the suitability area. Different standards and rules apply in the options and equity markets, and no such rules exist for commodities trading or trading in government securities. Yet in some cases the same salesmen are selling all of those instruments to the same customers as alternative investment opportunities. That situation should be remedied. The collateral effects of bad sales practices in any one area tend to spill over into others.

At the same time, it would be silly to think that the same old rules and procedures can simply be transplanted to each new instrument. Let me give you a few examples. Options transactions are more highly leveraged than stocks and, as a class, the likelihood of speculative risks is greater. Moreover, options strategies are more complex and harder to understand. The SEC staff's study of the options markets suggested that the existing suitability rules in the options area were simply inadequate to prevent many quite improper

sales practices. Now the options exchanges have adopted uniform suitability rules which are unique in requiring a registered representative to assess whether a customer is able to bear the risks of an options transaction and to evaluate the customer's financial sophistication.

On the other side of the coin, there are cases in the Ginnie Mae forward market that involve aggressive marketing of interest rate risks to small financial institutions. Whatever the lack of sophistication of the management of some of those institutions, it is very clear that the usual notions of what a securities salesman should do for an individual customer are not useful here. The customer is a financial institution. Other state and federal regulators have the responsibility of determining the propriety and safety of their investments. For better or worse, depository institutions are in the business of forecasting interest rate movements. Moreover, can we really expect a registered representative to second guess the bank's asset and liability management decisions?

At the same time, it would not be responsible for the Commission to simply walk away from that relationship; the evidence of abuse is too great. What is needed, I think, is a new definition of a broker's responsibility to financial institution customers. For example, I would think that the questions to be asked concern not the bank's "lifetime investment goals," but its investment manager's authority to act, limitations on the scope of that acitivity, the bank's ability to take delivery or to lay off that obligation on others; and the extent to which the purchase of securities of the type and quantity involved have been considered at an appropriate level of management.

Broker-Dealer Compensation

The Commission's concern with sales practices has even broader implications than our mandate to promote fair dealing with investors. Those practices have implications for the efficiency of the pricing mechanism and for allocation of capital as well. The efficient functioning of the market rests upon an assumption of rational choice. And if neither the customer nor the broker acts rationally -- the customer because he is relying on the broker, and the broker because he is motivated by some external factor -- then, at least in a marginal way, one of the basic assumptions of the market economy becomes eroded.

In general, we touch the registered representative-customer relationship at two points. First, to insure that the registered representative is adequately trained; and second, in retrospect, usually as a result of a complaint.

We do not examine, no less regulate, the compensation structure that determines so much of what registered representatives really do. Nor am I suggesting in any way that we should regulate those matters. But I do think we should have more information about compensation structure and its likely impact on the recommendations made by registered representatives. Once again, it is a question of the financial markets having shifted beneath our feet. When the number of different kinds of investment vehicles is quite limited, and each serves a distinct investment need, then the compensation structure is of comparatively little public concern. But when new equity issues, options, futures, forwards, standby commitments and other instruments all compete for the same high risk dollar, then the shape of the compensation structure has a very important impact indeed on which securities it is that are "sold and not bought."

In its options study, the Commission staff examined the way broker-dealers were compensating their registered representatives for effecting options transactions for customers. It concluded that the structure created substantial incentives to recommend options rather than equity secuities. One can and should ask similar questions about interest rate futures and other instruments.

I am not suggesting a major study or a concept release requiring public comment. I do think, however, that, as in the case of securities holding company activities, it is quite important that we begin to think about these questions and to debate them. If it should appear that there are indeed problems in some of these areas, the time to begin to deal with them is now -- not when we discover that what we thought was the status quo disappeared long ago.

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When regulatory change is forced upon us this way, the process of discerning the course of underlying trends is very difficult. Our glimpses of the future are always clouded. In that endeavor, the Commission values and welcomes your skeptical scrutiny, which Carl Sagan has called the process of winnowing deep insights from deep nonsense.

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Remarks to
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"How Much Can We Expect from Independent Directors?"

Stephen J. Friedman, Commissioner.

The growth of the power and importance of independent directors is a distinguishing characteristic of modern corporate life. The widespread use of audit committees is a testament, not to government pressure, but to the fundamental good sense of the idea. That development has found its full flower in the structure of investment companies. They are unique in existing under a legal system that requires many major decisions to be made by independent directors as a separate group. But even in the wider corporate world, the elaboration of the fiduciary duties of directors in conflict-of-interest situations -- such as going private transactions -- has developed similar institutions.

Today, I would like to discuss some of the limits on the usefulness of this very useful development. I approach that question not as an opponent of the institution of independent directors, nor even as a skeptic, but as a friend. Nevertheless, there are dangers in stretching good ideas beyond their natural elasticity. If a spring is stretched beyond its capacity, it remains misshapen and useless -- incapable of performing either its new function or the old. The same is true of ideas.

There are risks in over-reliance on the independence of directors. We may fool ourselves into thinking that we have dealt adequately with a problem that in fact remains unsolved, particularly in the conflict-of-interest area. That delusion may lead us to ignore market-based, or even regulatory, solutions that would be preferable. And if this device does not perform its intended function, there is real danger of overreaction. Legislative change in the regulation of financial institutions often grows out of scandal. If we ask independent directors to remedy what is irremediable, their failure may cast doubt on their other important and useful functions. Finally, and perhaps most important, if the coercive effect of the law is used to make independent directors perform in a way for which they may be unsuited, the result could be to transform the nature of the investment company.

Background

Disinterested directors have been assigned an important role in governing the affairs of investment companies since adoption of the Investment Company Act in 1940. In 1970, and again in 1975, Congress expanded their role.

Moreover, the evolution of this concept has included a sharpening of the whole idea of independence. In 1970,

Congress increased the extent of dissociation of outside directors from management by adding the concept of "disinterested" directors to that of "unaffiliated" ones. Because of concern about the ability of independent directors to control advisory fee levels, the 1970 Amendments added a duty on the part of the directors to request and evaluate, and a duty on the part of the company's investment adviser to furnish, information necessary to evaluate the terms of an advisory contract. Again focussing on the reality of the process, Congress required that the vote of disinterested directors with respect to investment advisory and underwriting contracts, as well as approving the selection of independent auditors, be cast in person.

The same scrutiny of the reality of the independence of directors has been present in the courts. In Tannenbaum v. Zeller, the court established a standard under which the existence or non-existence of a breach of fiduciary duty turned on whether the disinterested directors were: (1) dominated or unduly influenced by management, (2) fully informed and considered all pertinent factors, and (3) exercised reasonable business judgment. The opinion is remarkable in going beneath the formal independence of directors who are disinterested within the technical meaning of the Investment Company Act and asking for genuine and de facto independence from management.

The question of independence arose again in Burks v. Lasker. In that case the Second Circuit determined that disinterested directors lacked the authority to dismiss a non-frivolous suit against the management group because, among other things, their tenure in office was not independent of management and their relationship with management precluded their having the degree of independence necessary to determine whether a suit against management should be continued. On appeal, of course, the Supreme Court dealt with other issues.

Finally, the Commission has recently expanded the role of disinterested directors in the management of investment company affairs. In 1978, we began a study designed, among other things, to reduce the costs and burdens of regulation. The study was based on the proposition that investment companies should be permitted wider latitude in the exercise of business judgment, subject to the scrutiny of the disinterested directors. In effect, we have been experimenting with an alternative regulatory structure which relies even more heavily than before on disinterested directors. The success of this project depends, of course, on whether and to what extent it is feasible to enhance the role and independence of disinterested directors.

In the last two years, the Commission has adopted numerous rules granting exemptions from statutory restrictions conditioned on review and approval by disinterested directors.

The list is a long one, and shifts from the Commission to the independent directors the responsibility for approving many transactions that would otherwise be barred by Section 17. We recently adopted a rule that permits independent directors to approve use of fund assets for payment of distribution expenses by an investment company, a reversal (long overdue in my view) of a traditional Commission position. Although the procedures required for approval are arcane, the basic shift of responsibility from the government to the Board is significant.

Finally, in the recently adopted Small Business Investment Incentive Act, the Congress, with our support, provided for a transfer of much of the responsibility for approving transactions falling under the conflict of interest bar of Section 17 from the Commission to the Board of Directors of business development companies subject to the Act, provided that a majority of their directors (rather than merely 40%) are disinterested.

Thus, the trend is very clear. In assessing that trend, I think we have to ask ourselves what we can reasonably expect of outside directors. Their duties, it seems to me, fall into two general catagories: first, the monitoring function that is the primary job of all directors; and second, the review and approval of conflict-of-interest transactions -- those which involve transactions by the investment company with its sponsoring investment adviser. In thinking about those functions, it is useful to contrast the structure of an investment company with the structure of an industrial company, for they present two very different models.

The typical large industrial company has an independent life of its own, with employees, assets, products, customers, etc. It might be viewed as a going business in search of management. The directors set goals, monitor the management's progress toward those goals and its conduct of the ongoing business and, if necessary, obtain new management. If conflict of interest transactions are presented, the board scrutinizes them and makes a careful judgment, usually after employing an amount of the board's time and company resources that is out of proportion to the size and importance of the transaction.

In contrast, in the case of a typical investment company, the investment management services offered by the outside manager <u>is the business</u>. When a shareholder invests his savings, he is doing nothing more than purchasing the services of that investment manager. There is no separate product or sales force or good will in which the investor purchases a share. There is simply a pooling of funds for convenience of management. Put another way, the fund is a vehicle for

offering the services of a particular money manager. This structure has implications for review of conflicts of interest, but I would like to defer that subject for a moment.

There is, to be sure, an alternative paradigm that is closer to the industrial model. In that view of what is occurring, the investors' funds constitute the corpus of a trust. The trustees are charged with the custody of that corpus and their primary function is to select and evaluate those who invest the funds. The trustees of a profit-sharing plan are in much that position. The primary purpose of the plan is to serve as a repository for savings, not to offer a vehicle for the participant to be offered the services of a particular money manager.

I submit to you that the institutions we know as investment companies have plainly evolved along the lines of the investment management model, while the applicable legal principles of trusteeship and the regulatory structure are drawn from the profit-sharing model.

If I am correct, there are significant consequences for the responsibility of independent directors. I would like to examine that question with you in the context of the role of independent directors in approving

- -- the investment advisory fee,
- -- the investment adviser, and
- -- transactions with the investment adviser.

It is worth pausing to note that none of these actions present much problem for our prototypical profit-sharing fund trustees. They are free to shop around for the best combination of performance and low fee. Those who do not measure up are not hired -- or can be fired. Joint transactions with the manager or its affiliates present difficult matters of judgment, since there is no objective way of appraising them, but they are relatively rare and the cautious trustee may reject them as a matter of principle.

<u>Advisory Fee</u>

The size and structure of the advisory fee is quintessentially the kind of issue which we call upon independent directors to consider. The management of the investment company is identical to, or at least drawn from, the management of the adviser, and they can provide no independence of outlook or spirit in negotiating the fee. This is the kind of issue on which independent directors can make a contribution. But, if I am correct about the next point I want to make -- that termination of the investment advisory arrangement is seldom

perceived as a viable option -- then we are deluding ourselves if we think that the independence of the directors will produce the same result as a negotiation between the trustees of a profit-sharing fund and a prospective money manager. The practical inability to terminate the arrangement necessarily affects the bargaining position of both sides. The Congress recognized this difficulty when it adopted Section 36(b) of the Act, and imposed a fiduciary duty upon the adviser with respect to the receipt of compensation. I confess to some uncertainty about what was intended by that step, but it reflects a clear discomfort with the ability of the independent director to deal completely with the problem of excessive fees.

Nevertheless, I think there is a useful role for independent directors to perform in this area. They can examine the costs to the investment company of the services it purchases, and the kind of costs other institutional investors are incurring for similar services. They can review the manager's performance, its devotion of resources to the management of the fund, and its relative profitability. They can ask themselves -- and the manager -- whether extraordinary costs are justified. And in the end they could, I suppose, simply refuse to approve the contract unless the fee is reduced or restructured.

I might say in passing that if there are indeed limitations to what we can expect from the negotiations because of the inability of the board to take the ultimate step and seek a new adviser, then the fact that the shareholders can sue both the directors and the adviser for breach of fiduciary duty is not much comfort. There is no reason to think that a court, or a jury, will arrive at a fee that is fair under the circumstances. Indeed, it is not even clear to me what function the application of a fiduciary standard performs here -- except in the extreme case -- other than to emphasize that it is the shareholders' interests, not the manager's, that the directors are to serve.

Approval of the Adviser

In any event, let us move on to the question of approval of the adviser itself. Suppose a fund complex has for some years performed in the bottom quartile for pools of capital with similar objectives. If it were our own personal funds under separate management, most of us would move on to a new investment manager. Section 15 of the Act requires periodic consideration of the contract by the board and its independent directors. Section 15(c) requires the adviser to furnish, and the directors to request and evaluate, the information necessary to consider the terms of the contract. In theory,

at least, one would think that the board should consider other advisers. Yet the evidence indicates that is plainly not the case. And if my analysis of the nature of the investment company as an investment management service offered by the adviser is correct, it is not surprising and it should not be considered improper for the directors not to consider changing advisers (except, perhaps, under extraordinary circumstances).

It is an interesting reflection of that fact that, when renewal of the investment management contract is submitted to the shareholders for their approval, the proxy rules do not require that useful information on comparative performance be submitted to the shareholders. Indeed, that fact raises the question of whether any useful function is served by shareholder approval of the contract.

Finally, I should acknowledge that this result is not inevitable. A court or the Commission could decide that the fiduciary obligations of directors require them to act according to the second model -- like profit-sharing fund directors. One need only state that alternative in this way to see that such a decision would change drastically the whole investment company industry. An investor would not be buying the services of a particular adviser, but the adviser-picking abilities of a particular board of directors. The risks of being an investment manager for pooled public investments -- and therefore their charges -- would be greater. And in the end, what would have been accomplished? Would that be a more efficient mechanism than the current form, in which shareholders vote with their feet if they do not like an adviser's performance?

One may ask whether this analysis is merely an academic exercise. I think not, for in my judgment, it carries an important lesson. In an area like the choice of an investment adviser, we may delude ourselves if we focus too much attention on the "reality" of independence. Our public policy goals are better served by seeking a market-based solution. We should instead focus our efforts on improving the comparability of data from competing investment companies -- in both advertising and prospectuses -- and develop mechanisms to make it easier for shareholders to express their displeasure with investment performance by switching to other investment instruments.

An idea of this kind has been floated in somewhat different forms by Sydney Mendelsohn and others, and is currently under serious review by the staff of the Division of Investment Management. In broad outline, the notion is to permit funds to operate without the trappings of corporate democracy, provided that they impose no sales or redemption charges and that the investment adviser or manager provides all services in return

for a single fee. Participants would be in somewhat the same position as clients of an investment adviser. Rather than voting by proxy, they would simply vote with their feet. With the recent changes in our advertising rules and the development of standard reporting (at least for money market funds), we hope that investors will be able to do comparision shopping more easily than in the past and will have a variety of choices readily available. If increased market pressures come sharply to bear on funds, that may impose a discipline which will diminish the need for governmental regulation.

Transactions with the Adviser's Parent

Finally, I would like to turn to the role of independent directors in approving portfolio transactions with the adviser or its affiliates. That is the class of transactions encompassed by the prohibition of Section 17. Under the practice developed in administering that section, the Commission was required to review and approve each transaction. Because of the broad reach of Section 17's concept of affiliated persons, the Commission would have been required to approve a huge number of transactions. The time and expense involved in such proceedings meant, as a practical matter, that many transactions never took place. And those sectors of the investment management business where joint transactions are common, such as venture capital investing, were simply not conducted with public investors because of the strictures of Section 17.

That was not a very satisfying state of affairs from anyone's point of view. And so in rules adopted as part of the Investment Company Act Study, some of the responsibility was shifted to independent directors. The Small Business Investment Incentive Act went even further. When that bill was first introduced, its proponents proposed to eliminate Section 17 and the Commission's role entirely, leaving that area completely to the independent directors. We resisted that effort. The studies that gave rise to the Act in 1940 revealed serious abuses in the area of self-dealing. Was it a mistake on our part not to rely completely on the board?

In general, independent directors are perfectly capable of dealing with isolated transactions involving the adviser or its affiliates. Quite different kinds of problems arise, however, in those cases in which joint transactions are endemic to the whole concept. Here it might be useful to contrast two experiences of this kind -- the management by insurance companies of bond funds which included direct placements, and the management by banks of REITs.

Let me begin with the REITs. The history of that experience is still murky, and the problems of this industry were a melange of aggressive lending, an improvident failure to match assets and liabilities, and extraordinary bad luck in the sharpness of the interest rate cycle and its depressing effect on construction. But there were other forces at work. In the case of many banks and other participants in the mortgage lending business, the REIT's and their advisers were in essentially the same business. Putting aside, for the sake of analysis, any conscious wrongdoing, this situation is ripe for the realization of the consequences of human frailty. If in virtually every case a judgment is made by the adviser whether to make a loan itself or give it to the fund, or whether to recommend that the fund give a take-out commitment for the adviser's construction loan, then judgments that disfavor the fund may be matters of only a few degrees. Yet in cumulative effect, they could be very significant.

In that kind of a situation, it is hard to believe that independent directors can make much of a differences. Nor is there a useful market-based solution that offers much promise. By the time that the cumulative effects of those structural biases come to be felt, it is too late.

Thus, in some situations a regulatory solution is required. That does not mean an absolute prohibition, however. For example, an insurance company that sponsored a mutual fund which was to purchase some of the direct placements offered to the insurance company, adopted an arbitrary but effective policy:

-- all direct placements that are offered to the insurance company are also offered to the fund (if in accord with the fund's investment policies)

-- if the fund invests, so will the insurance company, and on the same basis and in the same amount.

-- all rights, such as conversion privileges, will be exercised at the same time.

This is hardly an ideal pattern in terms of flexibility. But it is an effective solution to the conflict of interest problem. It is interesting that the same kind of pattern was adopted by some insurance companies in their REIT activities.

Conclusion

In closing, I want to say a word about Sydney Mendelsohn. I have spend almost a third of my professional life in government, and I have been fortunate in sharing that experience with many talented people. Sydney Mendelsohn is clearly among the best. In a unique way, he shares a toughness in clinging to the regulatory goals he thinks are important with a mind that is willing to embrace new ideas as well as merely listening to them. The impressive steps we have seen in reducing the rigidity of investment company management are witness to that spirit. The Commission will miss him greatly.