Spring 1973

Bank Trust Department Investment Services for Correspondent Banks

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A number of the larger money center banks make available their trust division's investment research material to a variety of customers on a fee basis. Although begun as a service primarily for "correspondent banks", the type and variety of customers has been expanded and the services of some of the larger suppliers in this market are now analogous to those of registered investment advisers. These advisory activities often pre-date the recent focus on conflict of interest problems of trust departments. The advising of these clients represents another fiduciary relationship—with its own advisor-client characteristics and obligations—in the already impressive array to which a bank's management must be responsive.

In this article we consider the nature and economic bases of these advisory services offered by banks, some of the key problem areas which have become apparent in recent years, and some points that would seem to call for managerial, or in some cases regulatory, attention.

**Nature and Bases of Bank Advisory Services**

Initially, money center banks with large research staffs ("suppliers") made available their trust department investment research material ("service") to correspondent banks ("subscribers") in return for compensating balances. A number of the suppliers have now gone beyond this market and include among their customers insurance companies, pension funds, and individuals. A few also now compete for new customers mainly on the basis of the scope and quality of the supplier's investment advisory service.
The number of banks offering advisory services to correspondents is not known precisely, but according to informed participants in the market fewer than ten banks are significant factors and the entire market may not extend beyond thirty supplier banks. A larger number of banks provide occasional ad hoc investment advice to correspondents—answering particular questions or mailing out a variety of research reports—but these banks have not organized this activity on a systematic fee basis. A movement in this latter direction may be stimulated by the addition of non-bank investment advisory units (acquired, spun-off from banks, or newly created) as bank holding company affiliates. One curious feature of this market is that perhaps six of the suppliers are subscribers to the service of the other leading suppliers. Thus, the latter firms, recognized to be market leaders, serve as wholesalers as well as retailers of bank advisory service information.

The number of customers serviced by the larger suppliers in this market is still not large. The Harris Trust, a major competitor in this market, has over 200 subscriber bank clients. Another major supplier has just over 100 bank clients who constitute about two-thirds of its total advisory service clientele. In 1968, an officer of a third major supplier stated that:

We at the Bank of New York would like to think of ourselves as having from time to time been innovators in the field of trust investing. As you know, in addition to our own trust and investment counsel customers, we are privileged to work with over 300 banks, insurance companies, pension funds and other institutional investors in this country and abroad—the subscribers to our Investment Inquiry Service.

According to a more recent estimate, the number of advisory customers served by the Bank of New York is now about 1000.

Suppliers have entered this market for two main reasons. First, they have used it as another avenue for acquiring deposits and enlarging and consolidating customer relationships by offering an attractive service to investment managers who realize that they have less capability in this

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2. See introductory note * supra.
3. Id.
4. Young, Investment Management for ANY Size Trust Department, 111 TRUSTS & ESTATES 466 (1972).
5. See introductory note * supra.
7. This estimate was made in an interview conducted by the authors. The interviews with present and former trust department personnel were granted on the understanding that names would remain confidential and therefore neither the name of the individual nor that of his employer appears here or in similar citations below.
area than the suppliers. The role of this service is thus similar to other services rendered to smaller correspondent banks to attract them while at the same time taking advantage of efficiencies of scale or locational specialities accruing to large metropolitan institutions. Second, suppliers have wanted to make money directly by utilizing more fully their own research product and facilities. The overhead costs of a large research operation are considerable, and the additional (or marginal) costs of advising another client could be modest. It has been commonplace for years that even the largest banks have had difficulty in keeping quality security analysts, who have been bid away from them by Wall Street firms who reach out to service a multitude of institutions, and who have the great potential of large institutional commission rewards for research excellence. To some extent, therefore, the advisory services of banks have reflected their own struggles for economies of scale, the spreading of high overhead expenses associated with quality investment research operations, and the effort to enhance the profitability of the commercial bank trust department—a useful but sometimes only marginally profitable or actual loss division of the bank.8

The demand for advisory services from smaller banks and other institutions arises from parallel efficiency considerations. If the larger institutions have problems in fully utilizing and providing compensation and challenges to quality analysts and investment managers, these problems are more acute as trust asset volume diminishes. Of the over 3,000 banks with trust powers, no more than eighty manage assets of one billion dollars or more.9 As a general rule, the smaller the trust asset volume at a given bank, the greater the proportion of personal trust assets under management, with the attendant co-trustees and tax and investment constraints that reduce the institution's ability to continuously use its own research skills for investment decision-making on a volume basis. For the bulk of the smaller trust institutions, therefore, the development and internal generation of investment information is ruled out by cost considerations. For these subscriber banks, company visits and major independent investigations by trust department analysts are simply not available, to any significant degree, as bases for decision-making. Investment performance is therefore almost totally dependent on the quality of research acquired from the outside and the effectiveness with which it is put to use within the local bank.

There is great variation among subscriber banks in the way they use

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advisory services. The smaller ones tend to rely heavily on their supplier, in some cases with encouragement by supplier banks:

Having worked in a medium-sized trust department at one time, I feel that placing complete reliance on the organization that you have selected to assist you [as supplier] and on their analysts is a good thing to do, if you know . . . how to communicate with them. In other words, you can think of your research department being located in New York City even if you are located somewhere else.10

Some of the larger correspondent subscribers may buy advice from a number of brokers, institutional research houses, and other banks, whose output they may monitor and compare, perhaps relying on different institutions for different types of issues, or depending primarily on one service but hedging by checking out others.

Some subscribers may make all of their final decisions themselves after due consideration of the body of information they have purchased from others. At the other extreme, there are a number of correspondent trust departments that are fully dependent on the specific recommendations of one or more outside advisers—in a real sense they may have farmed out the decision-making to such outsiders. In quite a few cases, advisory service personnel of supplier banks have noted that clients are eager for something beyond mere investment information about securities followed—they want advice on precisely what they ought to buy and sell, as manifested, for example, in what the supplier itself is buying and selling; or they want specific buy-sell advice geared to their own portfolio needs and objectives.

The investment service usually is sold by a special marketing arm of the supplier’s trust division. Typically, it is sold to banks and others that have an ongoing, commerical relationship with the supplier bank. Selling and servicing is often a joint operation of the trust and commercial departments; the closer relationship and regular customer calls of commercial officers may make sales and service by them more economic. Customer referrals by the supplier’s commercial banking officers are usually the major source of new leads for the investment service. This is not always the case, however, as several of the leading banks offering an investment advisory service have used it as a vehicle for extending their business to banks with whom no previous commercial relationship existed.

It remains true, nonetheless, that competition in the furnishing of these bank-sponsored investment advisory services is limited to some degree by the edge given to supplier banks who already have established banking and business relationships with potential subscribers. In part this edge results from the fact that a small correspondent will attempt to garner as many services as possible in return for its existing deposit balances (often functioning as legal reserves for state banks) with its normal money center banks. These are artificial constraints unrelated to the quality of the investment service purchased.

There are sharp variations in the scope and quality of the services offered by different supplier banks, which limits still further the competition among them. Most bank suppliers provide only a single information service, consisting of a body of written materials mailed out weekly or monthly, plus occasional special reports. There is usually a call-in privilege, ordinarily confined to a specially designated officer or group within the supplier organization, and there are periodic gatherings (usually annual) at the advisor’s main office. There are, however, more complex arrangements similar to those provided by the larger brokerage houses. For example, one supplier bank offers the following grades of advice:

I. Basic Service — The subscriber receives some of the printed reports produced by the supplier and has the privilege of calling in with specific questions. The fee is a 100,000 dollar deposit balance in the supplier bank. [All fees are on a yearly basis; thus the deposit is an average or minimum for the same period.]

II. Expanded Service — The subscriber receives the Basic Service plus more written material. The subscriber receives the supplier bank’s internal purchase and sales list if he requests it. The fee is a 300,000 dollar deposit balance in the supplier bank.

III. Super Service — The subscriber receives the Expanded Service in addition to which the supplier bank will run several model accounts for the particular subscriber and will call the subscriber in case there is a development which will change an opinion on a stock that is followed. Because the supplier takes the initiative with respect to developments in stocks in subscriber accounts, supplier has a copy of the portfolios held by the subscriber. The purchase and sales list offered on request in the Expanded Service is automatically sent as issued. The fee is a 300,000 dollar
deposit balance in the supplier bank plus a 10,000 dollar cash payment.

The printed material distributed by a supplier bank typically includes the following: economics forecasts, corporate and municipal bond analyses, and reports on individual portfolio companies and industries. One bank lists the following research material as being available to subscribers:

- Estimate Changes (weekly)
- Decisions of the Week (weekly)
- Selected and Accumulation Lists (weekly)
- Code Book (monthly)
- Purchase List (monthly)
- Investment Policy Statement (monthly)
- Economic Review (quarterly)

Thus, a substantial part of the supplier's printed internal investment information is passed on to subscribers. Typically, this material is mailed to subscribers at the same time as, or shortly after, it is circulated within the supplier's own organization.

An additional service, as noted, is the call-in privilege, which permits subscribers to call the supplier bank and have questions answered. This is a key part of the service, according to one supplier bank officer:

> We have found [at United States Trust Company] that the material we send out is useful to our correspondents, [but] I think even more useful is their ability to call and reach the right person and get their questions answered. For this, we have available two or three men, who are account portfolio officers, and they are active portfolio officers, otherwise, I don’t think they could give the right advice. Through them, or directly, [correspondents] can talk to any of our analysts, economists, or whoever else there is on the institution team—sometimes on non-investment matters.

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I think the basic arrangement has obvious advantages, as long as you can be sure of your people and be sure of your lines of communication. This is what I know we had to be most careful about: that people really can get in touch with the people they want to in our organization.\textsuperscript{12}

Suppliers often filter questions by subscribers through prescribed channels (liaison personnel) thereby limiting direct access to trust department research analysts. The liaison people monitor incoming questions from subscribers and relay the responses given by the supplier’s security analysts. Liaison officers frequently “interpret” information and its relevance, sometimes deciding that investment advice is appropriate for “us” (the supplier), but not appropriate for “them” (the subscribers). In addition, liaison personnel may suggest that although a particular analyst has a given opinion the subscriber may safely ignore it because the analyst is not well qualified. Thus, through call-ins, a supplier may modify its general investment advice to better suit the needs of a particular client.

The call-in privilege also gives subscribers the opportunity to find out exactly what the supplier bank is purchasing and selling. Liaison personnel usually honor these requests for trading information. As one bank officer in charge of its service stated: “I will tell the correspondents what the bank is buying and selling in detail and keep them right up to date even though this may hurt us.”\textsuperscript{13} It appears that many of the subscribers put great weight on this trading information, regarding it as a shorthand way to determine what the supplier thinks of its own advice.

Some of the more refined and expensive services offer the subscriber the opportunity of having the supplier employ its own initiative to suggest new ideas or to modify previous recommendations. In that case, the advisory bank may maintain records of the portfolios of the subscriber (or at least its major components) and take the initiative in calling about stocks that are in these portfolios. This degree of attention is a response to the demand of smaller banks for what is essentially outside decision-making rather than mere investment information.\textsuperscript{14} Supplier banks have

\textsuperscript{12} Statement of Frederick N. Goodrich of the United States Trust Company in \textit{Improving Investment, supra} note 10, at 173-74.
\textsuperscript{13} Herman & Safanda, \textit{Allocating Investment Information, Fin. Anal. J., Jan.-Feb., 1973, at 23, 89} [hereinafter cited as \textit{Information}]
\textsuperscript{14} The existence of institutions operating trust departments which are heavily reliant on research information gathered by the supplier raises a question as to whether subscribers are acting independently in making investment decisions. It is a basic trust law principle that ministerial acts or duties may be delegated by trustees, but that duties involving discretion and judgment may not. See, e.g., Palmer’s Will, 132 N.Y.S.2d 311 (Sup. Ct. 1954); Kohler Estate, 348 Pa. 55, 33 A.2d 920 (1943). There may be a question as to whether subscribers to a Super Service who place complete reliance on the supplier are involved in an improper delegation of their discretionary duties.
been reticent to become involved with regularly reviewing subscriber portfolios, but will do this in special cases and for valued subscribers. A number of supplier banks do, however, run model accounts for their subscribers. According to one marketing officer, the model accounts are representative accounts that the supplier bank runs on a hypothetical basis. These models provide the basis for telephone discussions with the subscriber's trust department managers. Subscribers sometimes rely heavily on these model portfolios in investing funds for new accounts.

Suppliers are also asked to provide advice to subscriber banks on a variety of non-investment topics such as new trust business methods, security clearing, etc. In sum, offering a service of this character creates a complex web of relationships with subscribers, some of whose implications are considered below.

**Problems Arising Out of Bank Advisory Services**

We shall now discuss a number of specific issues arising out of supplier bank activities: efficiency effects; mode of subscriber payment; problems in the allocation of information; trading problems; and the effects of the commercial relationship.

**Efficiency Effects**

As we have noted, one purpose of offering bank investment advisory services is said to be the fuller utilization of research capabilities, and thus greater operational efficiency. The incremental cost of providing new clients with information already being generated for existing clients can be small. The reduction in overhead cost per unit-of-service may permit a

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A trustee may act upon the advice of others if he makes the final decision. Mills v. Bluestein, 275 N.Y. 317, 9 N.E.2d 944 (1937) (action based upon a report or assurance of another is not a delegation of duties or powers). See also Lutz v. Boas, 176 A.2d 853 (Del. Ch. 1961) (brokerage firm liable for management fee paid by mutual fund to investment adviser whose firm did the work for which the investment adviser was compensated).

Thus, a subscriber bank must—if it wishes to avoid an improper delegation—make the final decision regarding the particular securities to be sold or purchased for its accounts. As stated in Cooper v. Illinois Central R. Co., 38 App. Div. 22, 57 N.Y.S. 925 (1899):

> The investment of trust funds, the substitution of one security for another, the doing of any act by which the character or security of the trust investment may be in any respect changed or affected, these are matters that call for the exercise of judgment and discretion. . . .

*Id.* at 29, 57 N.Y.S. at 928.

Suppliers providing information to subscribers who are merely rubber stamping the recommendations of the supplier are thereby participating in a technical breach of trust.

Suppliers often complain that some clients are looking for assistance in actual decision-making, not merely advice on the characteristics of securities and security markets. Where these clients have received decision-making advice in the form of model portfolios and recommendations for specific purchases for specific accounts, effective decision-making may have been turned over to the supplier.
better or cheaper research operation. For these effects to be substantial, of course, the service would have to be sizeable; larger in fact than the investment advisory service of all but a few banks.

The efficiency effect of an investment advisory service may be compromised if the special needs of the individual advisory clients, or their ability to strike favorable bargains with the supplier bank, eliminate any economic advantage to the supplier bank or its trust department. The desire to build and protect the customer relationship is a primary purpose of the advisory service. Solicitude for the customer and consideration for other business done with him, now or in the future, might easily cause the resources devoted to the advisory service to exceed its revenues. Some banks, in fact, have found it difficult to extract satisfactory additional deposits from their correspondents in return for a new advisory service (which has led a few of them to try to make the service available only on a fixed cash fee basis). Supplier banks also find it difficult to establish fee levels that reflect the amount of contact and aid required by a clientele which varies markedly in investment sophistication and interest.

The net effect of the installation of an investment advisory service has been favorable for some of the larger suppliers, but for many other market participants the direct effects remain negative. Clearly, this result does not preclude substantial beneficial effects to the bank as a whole that are not reflected in the income statement of the trust department. For example, good service for correspondents may facilitate their retention as purchasers of other services such as municipal bonds underwritten by the supplier bank.

The effect of the development of an investment advisory service on the trust department's ability to service its internal accounts is likely to depend on circumstances in individual cases. If the advisory service is large, there is a possibility of an operational efficiency spill-over to other accounts, although the call-in privilege and direct allocation of resources to the needs of advisory clients may dissipate some or all of the potential net benefits to internal accounts. With small advisory operations, on the other hand, the possibility of negligible or negative (but probably still minor) effects is greater.

*Deposits as the Mode of Subscriber Payment*

The compensation of bank suppliers of investment services is usually taken in the form of a deposit balance from the subscriber. Deposit balances, as opposed to direct cash payments, can range from a low of about two thirds to a high of close to 100 per cent of advisory service compensation. Typically, the trust department receives an earnings credit for
generating commercial department deposit balances.\textsuperscript{16} Frequently, however, these credits do not fully cover the cost (to the trust department) of the services rendered.

Several issues may be raised by the dominance of deposit balances as the mode of payment for investment advisory services. For one thing, this reflects a breach in the "wall" between commercial and trust operations;\textsuperscript{16} the depositor-subscriber is usually a customer of the commercial arm as well as the trust department, and in some banks, as we have noted, the servicing and even the marketing of the advisory service is in the hands of commercial officers. Communications and negotiations must take place between the departments as to the allocation of deposit credits, and a conflict of interest between the departments is a conspicuous possibility. For example, the commercial arm may wish to accommodate a trust customer's demands for low advisory rates in order to strengthen its broader relationships with the customer, while the trust department may seek higher rates.

A second issue is the question of whether the commercial arm is purchasing benefits (deposits, better customer relationships) by the sale of information paid for by trust fees and commission dollars attributable to the supplier bank's own trust accounts. This would seem to be the case if one views the material distributed to subscribers as being an asset of the trusts under management and if this asset has not been contractually offered to the supplier as part of the management fee for these accounts. It could then be argued that the trustee is making an indirect profit from the use of a trust asset.\textsuperscript{17} This argument is hardly weakened when the

\begin{enumerate}
\item In one large supplier bank the trust department receives its compensation as follows:
  \begin{align*}
  \text{If the subscriber is required to maintain a $100,000 deposit balance with supplier and the prime interest rate is at 6\% (assuming that it stays constant for the year) then the profit to the supplier bank would be: } Prof & = [6\% \times (\$100,000 - \text{reserve})] - \text{cost.}
  \end{align*}
  In this particular bank, where the trust department is in a strong bargaining position, the "cost" figure is determined independently by the trust department and is equivalent to their personnel costs of providing the service, mailing and printing costs plus a share of the trust department overhead. Currently, the trust department is charging the commercial department an amount roughly equivalent to 4\% of the total required deposit. Supplier bank profits from the service are thus dependent on two factors: first, the spread between the prime rate and the "cost" figure, and secondly, economies of scale which operate to reduce this "cost" figure as more customers are added. This purchase of deposits by the commercial department may result in a loss for the commercial department if the prime rate drops or a loss of customers occurs.
\end{enumerate}

See introductory note \textit{supra}.

\begin{enumerate}
\item Herman & Safanda, \textit{The Commercial Bank Trust Department and the "Wall"}, 14 B.C. IND. & COM. L. REV. 21 (1972).
\item Basic fiduciary principles caution against trustees taking any indirect or secret profits by using trust funds:
  \begin{itemize}
  \item This rule [trustee's duty of complete loyalty] is sufficiently broad to embrace
  \end{itemize}
\end{enumerate}
Research sold is financed by commission dollars generated by the trust accounts. According to standard fiduciary practices, any value produced by these commissions should, it seems, revert back to the benefit of the trusts under management. Thus, when a supplier bank finances its research partly from trust generated brokerage, and then uses the advisory service to attract additional deposits from subscribers, it is using the commercial arm as an affiliate through which the supplier recaptures some of the value produced by these commissions. The supplier is, of course, refining the information received so that this is not a simple and direct recapture situation. The research product, however, is paid for by the fees and commissions generated by internal accounts.

Problems in the Allocation of Information

The effect of an advisory service on the timing with which information is made available to different accounts is complex. In general, we would expect the internal accounts of supplier banks to be favored because of the relatively strong personal relationships operative within the bank and the ease of communication within the confines of the trust department. This is not always the case, however, as some subscribers who are both aggressive and very good customers demand priority service; and

transactions with trust funds resulting in indirect profit to the trustee, such as commissions or compensation as brokers or bankers or for other professional or business services.


18. In earlier years, banks used the bulk of commissions derived from trading for trust accounts to acquire deposits that accrued to the benefit of the bank as a whole. This practice has become legally untenable. Fiske, How Banks Pass Out Commissions, INSTITUTIONAL INVESTOR, Dec. 1969, at 29, 30.

The recent imposition of negotiated rates on large securities transactions has tended to reduce the total brokerage to the bank; but out of the total still remaining, the purchase of research services for the trust accounts has been increased somewhat on an absolute basis, very substantially on a relative basis.

19. It is common for mutual fund prospectuses to contain language to the effect that investment information supplied to the management company in return for fund brokerage commissions is not “essential” and “does not necessarily reduce the expenses” of the management company (e.g., the management fee should not be reduced in return for the use of these “soft” commissions). Like supplier banks, management companies may use this information for other purposes—for example, to service investment counseling accounts—without crediting the fund for any of this “value” produced. Should negotiated rates drop to levels covering only pure execution costs, and should research be sold for “hard” dollars, one might argue that neither funds nor trust accounts could be tapped for research expenditures since this information is by admission not “essential”—purchasing research could arguably be a waste of assets by a fiduciary. In addition, the loss of this source of information would not increase the investment advisor’s “expenses” so that increased management fees could not be premised on the requirement of hard dollars for research.

20. Information, supra note 13 at 23, 91.
customers paying for "Super Service" may receive information at least as timely as many of the internal accounts.

The timeliness of information to subscribers may depend in part on the position and aggressiveness of the supplier bank advisory service's liaison personnel. Allocation of information favorable to subscribers may occur, for example, because the service's liaison officer participates in the meetings of the key stock selection committee and begins calling subscribers even before the minutes of the meeting are available to internal account portfolio managers. In addition, the call-in process may contribute to preferential treatment of at least some subscribers by making information available to correspondents before it has been digested and used by the supplier's own account managers.21

Despite this occasional preferential treatment the bulk of advisory service clients receive information less quickly than internal account managers and "Super Service" subscribers. Most advisory clients receive printed reports sent by mail, which normally reach them after the material has been distributed internally and to select outside clients.

This variable timing in the availability of investment information gives rise to a number of potential conflict of interest problems for banks. Are the secondary recipients of information aware of their lesser status? Are they made aware of whether and when the bank is buying recommended securities for its discretionary accounts? Does the delay work to their detriment as investors and to the advantage of those accounts receiving information first? Does the lack of formal and consistent procedures by banks in the distribution of timely information result in an unplanned and chaotic sort of discrimination among customers? Are these conflict possibilities likely to materialize in quantitatively significant effects? For a trustee of multiple trusts, differentiation of treatment by classes of clients will certainly be legally hazardous without adequate disclosure to interested parties. Even with disclosures the situation is not entirely clear.

The standard of conduct to be observed by an investment adviser in allocating information between accounts has rarely been litigated. In the few relevant cases, litigation usually has arisen where an adviser or the adviser's personnel were dealing with information in a manner that benefited their own institutional or personal accounts. This litigation has typically been based on the application of fraud concepts under rule 10b-5.22

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21. Concern for non-discretionary internal accounts has been expressed, as follows, by a trust officer of the First National Bank of Chicago:
   We manage numerous accounts, and on many we have co-trustees or consultants.
   When we are rapidly liquidating our position in falling star airlines do our "consult" accounts get what is left of a "bombed out" market?

Suppliers provide a variety of written material for their subscribers and these activities are not unlike those of other investment advisers who publish "market letters". In *SEC v. Capital Gains' Research Bureau, Inc.*, defendant Capital Gains and its owner, both registered investment advisers, published a monthly report of broad circulation which gave advice on particular securities. On several occasions the investment adviser purchased or sold short, shares of a security before recommending it in its report and sold or covered the shares within several days after publication of the recommendation. Defendants engaged in this practice, known as "scalping", without disclosing either the purchase or sale to their clients. The Commission sought an injunction to compel defendants to disclose this practice. The Supreme Court upheld the grant of an injunction reasoning, in part, that defendants were fiduciaries with respect to their advisory clients and, as such, must avoid placing themselves in conflict of interest situations and must make full disclosure to their clients before engaging in trading of this sort. Thus, non-disclosure of information material to an evaluation of the disinterestedness of investment advice is one variety of securities fraud. The rationale for this conclusion is that:

An adviser who . . . secretly trades on the market effect of his own recommendation, may be motivated—consciously or unconsciously—to recommend a given security not because of its potential for long-run price increase (which would profit the client), but because of its potential for short-run price increase in response to anticipated activity from the recommendation (which would profit the adviser).24

Supplier banks, although not subject to the Investment Advisers Act and its registration and reporting requirements, are subject to the same broad fiduciary duties.25 Thus, a supplier who acquires a position for favored accounts in a security about to be recommended may be "scalping" some subscribers and less favored accounts in violation of rule 10b-5.26


[W]e have encountered situations, where some well known investment advisory firms whose recommendations carry weight, the mere fact that X & Co. says that the stock is a buy is likely to lead not only X & Co.'s numerous customers
In the *Kidder, Peabody* case, the manager of the Kidder, Peabody Special Investment Advisory Service, a registered investment adviser, made preferential transactions for certain clients. The manager and certain of his relatives participated in the Special Service and their accounts purchased or sold before other accounts, at prices which were more favorable. The Commission in dealing with Kidder, Peabody's offer of settlement stated the facts to be that:

Although certain of Goodnow's [the manager's] clients from time to time may have been informed generally that Goodnow was engaging in transactions in the same securities being recommended to them and acquired for their accounts, or that Goodnow had acquired a position in such securities, registrant did not adopt any specific policy of requiring specific disclosure of Goodnow's activities to clients unrelated to Goodnow, and no such disclosure was included in the printed recommendation and consent cards sent to clients in consummating transactions in the Special Service. Accordingly, when specific purchases or sales were made for individual advisory clients, such clients were not informed of the nature, terms and sequence of the purchase or sale for the personal account of Goodnow or for the accounts of Goodnow's relatives.

The Commission's conclusion was that:

The Advisers Act was aimed at eliminating conflicts of interest between an investment adviser and his clients. Consequently, an investment adviser must not effect transactions in which he has a personal interest in a manner that could result in preferring his own interest to that of his advisory clients. Furthermore whenever trading by an investment adviser raises the possibility of a potential conflict with the interests of his advisory clients, the investment adviser has an affirmative obligation before engaging in such activities to obtain the informed consent of his

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28. *Id.* at 83, 322.
clients on the basis of full and fair disclosure of all material facts.\textsuperscript{29}

Broadly speaking, the *Kidder, Peabody* decision requires, among other things, the disclosure of material facts which would be helpful to a client in evaluating the adviser's motivations in recommending a particular security—whether the motivations be obvious or merely holding forth a potential for influencing investment judgment. Such a requirement may have broad application to supplier bank investment advisory services, since subscribers may have a legitimate interest in obtaining facts about the "nature, terms and sequence of the purchase or sale" of those recommended securities which are traded for preferential internal accounts.

With respect to selective dissemination of research information, several recent pronouncements by the SEC raise questions as to the normal method of supplier operations. In its Future Structure Statement, the SEC stated:

[W]e believe that a broker is obliged to communicate any material changes in his prior investment advice arising from subsequent research he may do to all customers whom he knows have purchased and may be holding shares on the basis of his earlier advice, at least under circumstances where to do so would not impose an unreasonable hardship on the broker.\textsuperscript{30}

In the *Butcher & Sherrerd* case,\textsuperscript{31} the brokerage firm consented to an SEC finding that it had violated its obligation to deal fairly with all customers,\textsuperscript{32} when, after changing its investment opinion of Penn Central stock, that change was communicated only on a selected basis to certain

\textsuperscript{29} Id. at 83, 324.


\textsuperscript{32} In a letter to all of its customers dated December 15, 1972, Butcher & Sherrerd discussed the SEC settlement as follows:

The SEC's criticism concerns the internal operations of Butcher & Sherrerd. It relates to the firm's procedures in disseminating the sale recommendation, in assuring that the recommendation was passed on to all of our customers, and in regulating the sequence in which all holdings were sold. Neither the SEC, nor any national security exchange nor the National Association of Security Dealers, nor any other regulatory agency had then, nor for that matter has as yet, promulgated any rules or guidelines to assist the securities industry in determining what procedures should be followed in disseminating a change in recommendation with regard to a security. . . . The procedures which Butcher & Sherrerd followed were in line with those prevalent in the industry and one which it believed to be proper. . . . No customers were given intentional preference over others. Obviously, all could not have been contacted simultaneously.
preferred customers, and not to others who still held shares of the stock 
which they had purchased on the firm's recommendation. These SEC 
pronouncements give little guidance as to what conduct might be deemed 
"fair" in an altered factual context, but they do suggest, once again, that 
a supplier may be held to fiduciary standards of conduct—principally the 
duty to treat all clients fairly—in dealing with subscribers. When a sup-
plier's conduct is judged "unfair", liability may be imposed for breach of 
fiduciary duty.4

A critical fact, then, is the nature and amount of disclosure made by 
suppliers to subscribers; particularly disclosure as to those practices which 
give rise to potential conflicts of interest in the allocation of investment 
information. In many cases, regular investment advisory subscribers 
are aware of their status as secondary recipients of information, since 
they are told the different characteristics of ordinary versus "Super 
Service" in the process of negotiating an advisory relationship. Presum-
ably they choose a lesser service on grounds of price and/or their estimate 
of their own needs. Besides this presumption of a knowledgeable choice, 
common sense should make their secondary status clear to many sub-
scribers. There may be exceptions to this assumed subscriber awareness, 
however, where salesmen stress the merits of a particular service thought 
to be acceptable to a client or where a client is limited in his choice because 
of constraints on the use of his deposits: in both cases, the subscriber 
may not be motivated to investigate the other form of service. Finally, 
where the supplier offers only one type of service, there is less reason for 
explicit mention of delays.

Subscribers to regular (as opposed to Super) service are generally 
not told whether the supplier bank has bought or sold recommended 
securities for its discretionary accounts. If the bank recommends a

1972).

34. Based on general trust law principles of loyalty and fairness, one court dis-

cussed the trustee's standard of conduct as follows: 
[T]he handling of multiple trusts, of necessity, calls for a high degree of care 
and a sense of extreme loyalty upon the part of a trustee as to each of his 
various trusts. It must be evident that this obligation is made more difficult as 
the size and number of the trusts for which he is trustee increase. . . . In 
oral argument it was stated that at least one trust company in Cleveland is 
trustee for more than 5,000 separate trusts. Under such circumstances, un-
divided loyalty to each trust is obviously almost an insuperable task, since there 
must exist a temptation and the urge of special circumstances to favor one 
trust over another in times when changing markets and other considerations 
make some securities desirable and others already in hand undesirable. Noth-
ing but extreme diligence and fair dealing will, under the law, exonerate a 
trustee placed in such circumstances.

In re Binder's Estate, 137 Ohio St. 26, 34; 27 N.E.2d 939, 946 (1940).
security, it might seem reasonable to assume that the bank has bought or will buy it for internal accounts, but this is not always the case and it remains true that many advisory service clients do not know what the supplier bank has done. Furthermore, supplier banks often do not "recommend" securities in the written reports sent out to advisory clients—they try to stick to factual presentations and estimates, and general evaluations of quality, eschewing specific buy-sell advice. By this means, they reduce their own involvement in advisory client decisions, and, hopefully, their own potential conflict with client decisions arising out of that advice. The problem is that the concept of "neutral" advice may be difficult to sustain, and recommendations may creep in by the back door (e.g., in changes in language used, or via remarks from bank personnel responding to a call-in).

Since the supplier has promised both internal accounts and selected subscribers that they will receive timely information, it is of some interest as to how banks proceed in situations where there is an immediate, compelling change dictated by newly received information. Few banks have established rules and procedures that would alleviate allocation problems in a case where timeliness may be important. What is likely to ensue is the diffusion of this information from select internal and "Super Service" clients out to the lesser clients, with the latter receiving the information according to aggressiveness and chance (timeliness of their call-ins, for example), and to the vicissitudes of the mails.

Some bankers claim that the problem of delayed or selective receipt of information is unimportant because: (1) the recipients of bank advisory services are sophisticated; (2) the bank could not afford to mistreat any of its subscribers because of their importance to the bank; (3) the differences in objectives (and the conservative, long term investment orientation) of most subscribers makes timeliness less consequential; (4) the time lags are too short to be operationally significant; and finally, (5) "hot information"—information so important and so reliable that it must be acted upon, but still usable within the limits of the securities laws—is virtually nonexistent.

The experience of the larger suppliers in operating these services is not compatible with the conclusion that subscribers are sophisticated or that timing in the receipt of information is unimportant, especially where a supplier offers several levels of service. These issues are complex, but even if the quantitative significance of allocational inequities is not great, differentials in the receipt of timely information creates problems that must be dealt with by supplier bank managements.

35. Some of these issues are treated in Information, supra note 13.
**Trading Problems**

The discussion of the trading problems of supplier banks will be divided into two parts: trading by the supplier, and trading by supplier bank research personnel and portfolio managers. The concern here arises out of the potential of the supplier for affecting the market in recommended securities. This ability results from the supplier bank's sole possession of pre-publication knowledge concerning the content of its future recommendations to subscribers.

1. Trading by the supplier

   One of the problems confronting many of the larger trust departments is the effect of their trading—when buying or selling for a large number of accounts—on the market price of an issue. Given the market power, over the short term, of a large supplier with a substantial subscriber clientele, an investment recommendation by the supplier may be a self-fulfilling prophecy. In part, the problem has been brought about by a change in the investment philosophy of many trust institutions who have now chosen to concentrate their substantial trust investments in a relatively small number of issues:

   It is obviously important to abandon broad diversification as the traditional safety valve against undue risk. You may be interested to know that as large a Trust Company as we [United States Trust] are, twenty of our largest common stock holdings represent over fifty per cent of the market value of all common stocks held here at the Trust Company. In lieu of broad diversification one should substitute selectivity and improve that selectivity.\(^{36}\)

   It is true that most bank subscribers have been conservative buyers of N.Y.S.E. blue-chips with large capitalization, but in an effort to achieve better investment performance a number of subscriber clients have been willing to assume increased risks and invest in stocks with smaller equities. Investment in stocks with smaller capitalization enhances trading problems, because with these thin securities there is a greater likelihood of wide price fluctuations when supplier banks are making major trading moves.\(^{37}\) Where an investment in a thin stock is planned by a supplier bank, potential conflict situations may easily arise.

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36. Fisher, supra note 11, at 681.
37. For evidence that institutional investors can have some impact on the price of the stock of smaller and less seasoned companies, see I. Friend, M. Blume & J. Crockett, Mutual Funds and Other Institutional Investors, Twentieth Century Fund (1970).
Assume a supplier bank possesses knowledge of a prospective increase in price based on its own contemplated investment in a thin issue. In this case, the supplier has the potential to create preferential trading sequences to the advantage of select internal accounts or select subscribers with little opportunity for other clients to discover this pattern. As subscribers and internal accounts act on the supplier's initial recommendation, the supplier will become more important—directly, or indirectly as the source of the recommendation—in the market for a particular company's stock. Without adequate institutional disclosure, it is not possible for a subscriber to determine what effect the supplier bank's activities are having on the market price of the issue. Currently, supplier banks are not making any periodic, formal disclosures of their trading activity in recommended stocks. In addition, some supplier banks do not formally warn their subscribers of the limited marketability of recommended issues.

By serving both internal accounts and subscribers, the supplier as fiduciary is thus placing himself in a position requiring him to exercise extreme diligence in order that both types of clients are dealt with fairly. The supplier must execute transactions for internal accounts in such a manner that the client's total cost or proceeds are the most favorable under the circumstances. If the sequence of discretionary purchases by the advising banks or the time sequence of information flows to different grades of customers is likely to result in a built-in price disadvantage for certain classes of advisory clients, it is possible that this potential may have to be made very clear and explicit by an advisor wishing to avoid liability within an inherently discriminatory structure.

2. Trading by supplier bank personnel

Trading by bank personnel on the basis of pre-publication knowledge is not subject to active supervision by the banks, and the rules governing conduct here are generally enforced by the "honor system". Trading by

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   One of the basic duties of a fiduciary is the duty to execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances.
40. Employee trading becomes more than an ethical problem where the supplier bank has represented that it is free from conflicts of interest. In one bank where employee trading is governed by the "honor code," prospective customers are given promotional literature that states:
   No estate or trust buys from or sells to another trust account. The Bank itself does not trade in securities of any trust account—and the same rule applies to officers and employees as individuals. Not only is this a long standing policy of the Bank, but is also strictly enforced by the Bank examiners.
Under the honor code applied in this bank, no one knows whether the bank's policy has
bank personnel on the basis of internal information does occur, although on a scale inherently difficult to ascertain. Where a bank is running an investment research service, there is the potential for the supplier's account managers to purchase recommended issues for their personal accounts before the recommendation is communicated to subscribers. Given the fact that a large number of subscriber institutions may be acting on the basis of the supplier bank's recommendation, trading on the basis of this anticipated demand or supply could prove profitable for an individual with access to pre-publication information. Moreover, absence of disclosure requirements enables supplier bank personnel to operate relatively free of liability risks.41

Commercial Customer Constraints on Investment Advice

In the marketing of information services to correspondents and other subscribers, suppliers represent that the advice given is not only competent but that it is also disinterested. Several subscriber banks have stated that they chose a bank-sponsored rather than a broker-sponsored service because of the impartiality of a bank research staff in appraising a company's prospects and the absence of commission generation as a motive for their recommendations.

Although the criteria for choice may be valid on a relative basis, it is sometimes not fully disclosed to a subscriber that there may be unstated constraints placed upon the supplier's investment advice resulting from its commercial relationship. Reports written by analysts which are available for distribution to subscribers often are toned down or relayed verbally if they may offend valued commercial customers of the supplier. Thus, the content of a report reaching subscribers may be unlike the original if it is potentially dangerous financially for the bank to publish uncomplimentary statements about its commercial customer. It appears that supplier bank analysts have experienced problems in attempting to have the stocks of good commercial customers removed from the bank's approved list; commercial pressures have often gathered to defeat these attempts, and the analysts affected feel that the customer relationship precluded removal irrespective of investment merit.

Problems of a conflict nature also may arise where the supplier makes a trading recommendation about a commercial customer that is currently engaged in financing operations with the bank. For example, a supplier could recommend a stock which was issued, in part, to pay off loans made

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by the supplier.42 One may expect commercial department interests to be intensified when the safety of loans or their repayment is in question.

Conflicts of this variety go to the very nature of the advice being sold to subscribers. There is a real question, of course, whether conflicts of interest arising out of commercial relationships are quantitatively important. The Institutional Investor Study data suggested a surprisingly small impact on the composition of trust department portfolios arising out of commercial relationships;43 whether the impact on investment advisory service clients would turn out to be larger is an open question.

CONCLUSIONS AND RECOMMENDATIONS

The business of trust departments of commercial banks has gradually changed from one principally oriented toward the conservation of the assets of testamentary trusts, under court supervision, to the management of assets of a variety of investor types with different objectives, relatively free from outside supervision.44 Today, the operations of large trust departments are important factors in the market for investment advice.

The establishment by banks of investment advisory services for the benefit of subscriber banks adds further complications to an already impressive set of potential conflicts of interest. Such advisory services bring with them a new avenue for deposit-buying in the interests of the bank as a whole. Also, the possibility of discriminatory treatment in the provision and use of information among different classes of customers—already a problem among the various types of internal accounts—is enhanced by the establishment of new groups of external customers.

The extent to which banks have neglected to deal with these problems ex ante, prior to a legal or legislative onslaught, is reminiscent of their handling of trust departments, uses of brokerage to purchase deposits, or the insider problem in the 1960s and earlier.

Currently, supplier banks are relatively unsupervised with respect to the operation of these services—on the theory that the services are being

42. As evidence of the fact that a bank might find this an acceptable practice, the First National Bank of Chicago in the Declaration of Trust for its Group Fund A for Pension and Profit Sharing Trusts includes the following language:

Section 6.3 Investments.
No investment shall be deemed improper or imprudent merely because the Bank has participated in any way in the issuance, underwriting or original sale thereof, or because a part or all of the proceeds received by the issuer or seller are used or to be used to satisfy any obligation to the Bank.


44. Several trust companies have recently been organized without traditional commercial banking facilities, but with trust operations, to take advantage of the exemption from registration existing for trust companies under the Investment Advisers Act. Investment Advisers Act of 1940 § 202(a) (11) (A), 15 U.S.C. § 80b-2(a) (11) (A) (1970).
offered to sophisticated institutions that need little protection via traditional forms of regulation; partly also because suppliers and subscribers are subject to some form of regulation already; and partly in the belief or hope that the forces of competition will force suppliers to play a fair game.\(^5\) These assumptions should be re-examined because: (1) services are being offered to individuals as well as to institutions; (2) the investment acumen of many of the subscribers cannot be assumed; and (3) the forces of competition have been only partially successful in penetrating the larger community of interests existing between particular suppliers and subscribers, who frequently have well established commercial correspondent relationships.

As a result of our examination of this area, the following recommendations may be made:

(1) It would seem a desirable protection for both supplier banks and advisory clients that there be written disclosure of any actual or potential preferential sequences in the receipt of information or trading in recommended securities. This is done informally by many banks in explaining to internal customers why the bank should be given full investment discretion. This principle should be extended and formalized.

(2) It would seem desirable that trading information be provided by supplier banks to all subscriber clients in a form that would set forth, for successive time periods, the transactions in recommended securities made by supplier banks for their trust department accounts (with some minimum dollar value of transactions fixed to avoid trivial purchases and sales). No other trading information could be given out by a supplier. By this process, only the discretionary accounts of the supplier bank could benefit from trading by discretionary accounts themselves.

(3) It would seem desirable to have full disclosure to supplier banks and to some supervisory agency of all trading by bank officers and trust department personnel in securities held or recommended by the supplier bank.

(4) Where securities of commercial customers are analyzed and evaluated for the benefit of advisory service clients, the existence of com-

\(^{45}\) A similar argument was offered by the Comptroller of the Currency in 1967, in connection with bank underwriting of revenue bonds:

\[P\]roviding correspondent services, of which investment portfolio advice is but a part, is a highly competitive business. To contend that an underwriting bank would recommend inferior securities to its customers because it underwrote such securities is unrealistic. The risk of losing correspondents will afford adequate assurance that the underwriting bank will give the best possible advice to its correspondents.

commercial relationships should be disclosed. A commercial customer could be defined as any issuer having a line of credit from or a deposit account at the bank in excess of a given amount, say 100,000 dollars. Interlocking relationships of personnel should also be specifically disclosed to subscribers.
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