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Securities Fraud – Fraudulent Conduct Under the Investment Advisers Act of 1940

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compensation for genuine injuries to a large number of passengers whose hapless fate it is to be called 'guests' under an arbitrary statutory classification."[55]

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SECURITIES FRAUD—FRAUDULENT CONDUCT UNDER THE INVESTMENT ADVISERS ACT OF 1940

The respondent published an investment advisory report which it distributed to its subscribers. This report was designed to furnish analyses of various companies and their securities and to make recommendations concerning investments in these securities with a view to the realization of long term capital gains by the subscribers. On five occasions within an eight month period, the respondent purchased recommended securities several days prior to the publication of its investment report.[1] After publication, the respondent sold its securities on a rising market and thereby realized short swing profits. The respondent made no disclosures to its clients of its dealings in the recommended securities. Alleging that the respondent's activities constituted fraud or deceit within the proscription of the Investment Advisers Act of 1940, the SEC sought a preliminary injunction to require the respondent to disclose to its clients its interest in recommended securities. The district court denied the injunction on the ground that the SEC had failed to establish fraud or deceit as required by the act.[2] This decision was affirmed on different grounds by a panel of the Court of Appeals for the Second Circuit[3] and again on rehearing by the court sitting en banc.[4] On certiorari to the United States Supreme Court, *held*, reversed: the failure of a registered investment adviser to disclose transactions for his own account in securities which he recommends to his clients operates as fraud or deceit within the scope of the Investment Advisers Act of 1940 and the SEC may obtain an injunction to require disclosure of these activities.[5] *SEC v. Capital Gains Research Bureau, Inc.*, 84 Sup. Ct. 275 (1963).

L.J. 38 (1952); Lang, *The Nature and Potential of the Saskatchewan Insurance Experiment*, 14 U. FLA. L. REV. 352 (1962).

55. Note, 47 IOWA L. REV. 1049, 1063 (1962).

1. On one occasion, the respondent sold a stock short. Ten days later, in its report to its subscribers, the respondent discouraged investment in this stock. Thereafter, on a declining market, the respondent covered its short sale and thereby realized a profit.

2. SEC v. Capital Gains Research Bureau, Inc., 191 F. Supp. 897 (S.D.N.Y. 1961). The court held that fraud and deceit must be established in their technical sense and there must be an intent to injure or actual injury sustained by the clients.

3. SEC v. Capital Gains Research Bureau, Inc., 300 F.2d 745 (2d Cir. 1961). It was the opinion of the court that the test to be applied was whether the recommendation was honest when made. The SEC did not allege that the report contained misstatements or false figures.

4. SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606 (2d Cir. 1962).

5. This practice is known in the industry as "scalping."

The passage of the Investment Advisers Act reflected congressional concern with the substantial growth of the investment advisory business and the important role it was assuming in the securities industry.[6] By its passage, Congress sought to establish some measure of control over this previously unregulated business.[7] The primary purpose of the act was to protect investors from those whose superior knowledge of the securities industry enabled them to capitalize on the credulity of the less financially sophisticated members of the public.[8] The Senate report accompanying the bill which was approved by Congress stated that "the public [must] be protected from the frauds and misrepresentations of unscrupulous tipsters and touts. . . ."[9] In order to effectuate this purpose, Congress proscribed, in broad terms, fraudulent and deceitful practices,[10] employing terminology quite similar to that utilized in earlier securities legislation.[11]

The concept which pervades the federal securities law—full disclosure—was embodied in the Investment Advisers Act, explicitly in some of its provisions,[12] and implicitly, according to the instant case, in its fraud provisions. Prior to the instant case, it was stated that the fraud provisions of the Investment Advisers Act, sections 206(1) and (2), were "modeled on Clauses (1) and (3) of § 17(a) of the Securities Act";[13] and therefore, that which was applicable to the latter applied to the former "mutati mutandis." Consequently, non-disclosure of a material fact, which would constitute fraud or deceit under the Securities Act of 1933, would lead to the same result under the Investment Advisers Act.[14] This view finds further support in common law and

6. The occupation of investment adviser developed after World War I, and by 1939 when the Investment Advisers Act was being considered by Congress, 51 firms managed, supervised or gave advice concerning investments of four billion dollars.

7. *Hearings Before a Subcommittee of the Committee on Interstate and Foreign Commerce of the House of Representatives*, 76th Cong., 3d Sess. 86 (1940).

8. S. REP. No. 1775, 76th Cong., 3d Sess. 21 (1940). Another purpose was to protect bona fide investment advisers from the stigma resulting from the activities of unscrupulous advisers.

9. S. REP. No. 1775, 76th Cong., 3d Sess. 21 (1940). In a case involving other federal securities statutes, the court stated that "the business of trading in securities is one in which opportunities for dishonesty are of constant recurrence and ever present." Archer v. SEC, 133 F.2d 795, 803 (8th Cir. 1943).

10. The Act, in pertinent part, provides as follows:

> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly (1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. . . . 54 Stat. 852 (1940), as amended, 15 U.S.C. § 80(b-6) (1958).

11. Securities Act of 1933 § 17(a), 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77q(a) (1958).

12. *E.g.*, 15 U.S.C. § 80(b-6) (3) (1958). See Norris & Hirshberg, Inc. v. SEC, 177 F.2d 228 (D.C. Cir. 1949) and Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943) concerning the disclosure requirements of broker-dealers.

13. 3 Loss, SECURITIES REGULATION 1515 (2d ed. 1961).

14. Arleen Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949). In the *Hughes* case, the vio-

equitable concepts of fraud and deceit[15] and earlier Supreme Court cases equating express misrepresentations and concealment.[16]

Additional support for the requirement of full disclosure by an adviser of his position in a security may be derived from the congressional recognition of the principle that an adviser's function is to render competent and unbiased advice.[17] An earlier case indicated that the failure to disclose an interest in a recommended security when the recipient of the advice justifiably believed it to be impartial constituted deceit.[18] If an adviser is properly to perform his function of rendering competent and impartial advice, he must be free from all conflicts of interest.[19] This becomes particularly significant when an adviser is deemed a fiduciary[20] or an agent[21] for his clients, in which event the duty of full disclosure becomes more pronounced. The common bond between all these factors which led to the requirement of full disclosure is the expansive scope and liberal interpretation given to all the securities laws.

Although the foregoing reasons support the decision in the instant case, certain factors existed at the time of the enactment of the Investment Advisers Act which are in conflict with this rationale. When Congress was considering the act, industry representatives stated that "trading by investment counselors for their own account in securities in which their clients were interested may adversely affect the interest of these clients. . . ."[22] Faced with this particular problem raised by persons who were to be regulated by the act, Congress still took no specific steps to alleviate it, although special provisions were placed in the act to obviate other specifically enumerated problems.[23]

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lations were somewhat more pronounced than in the instant case. The defendant acted in the capacity of a broker-dealer and an advisor. In the course of her dealings with her clients, the defendant failed to inform them of the price at which the securities purchased for them could be obtained in the open market and the cost to her of the securities which she sold to her customers.

15. PROSSER, TORTS § 87 (2d ed. 1955).

16. *E.g.*, Strong v. Repide, 213 U.S. 419 (1909).

17. H.R. Doc. No. 477, 76th Cong., 2d Sess. 28 (1939).

18. SEC v. Torr, 15 F. Supp. 315 (S.D.N.Y. 1936), *rev'd on other grounds*, 87 F.2d 446 (2d Cir. 1937). The factual situation in the *Torr* case and the case at bar are quite different; in the *Torr* case, the "advisers" were to receive compensation from the defendant, who had an interest in the recommended stock, the amount of the compensation being dependent on the number of shares sold.

19. H.R. Doc. No. 477, 76th Cong., 2d Sess. 28 (1939).

20. SEC v. Capital Gains Research Bureau, Inc., 300 F.2d 745 (2d Cir. 1961) (dissenting opinion); SEC v. Torr, 22 F. Supp. 602 (S.D.N.Y. 1938) (final hearing on an injunction).

21. 3 Loss, SECURITIES REGULATION 1503 (2d ed. 1961).

22. H.R. Doc. No. 477, 76th Cong., 2d Sess. 29-30 (1939). It is interesting to note that although one of the stated objectives of the act was the elimination of conflicts of interest between advisers and their clients, it contained no express provisions relating to "scalping." Although the problem of "scalping" was raised by industry representatives, the code of ethics of the Investment Counsel Association of America did not proscribe scalping.

23. Among other provisions, it was suggested that an adviser's compensation should not be contingent upon profits realized by a client and that advisory contracts should be non-assignable. Both of these suggestions were codified in section 205 of the Investment Advisers Act.

As previously noted, the act's fraud provisions were taken from the Securities Act of 1933. One provision in the Securities Act, explicitly proscribing omissions to state material facts, was not included in the Investment Advisers Act.[24] This fact alone probably would not negate the proposition that the fraud terminology employed in the act was intended to encompass non-disclosure, as "one variety" of fraud.[25] However, if this were the intent of the act, there would have been no need for any specific proscription of "omissions," and yet, in the section of the act which prohibited fraud in general terms, the act proscribed non-disclosure in an adviser's purchases from or sales to a client.[26]

Subsequent to the enactment of the act, congressional and administrative authorities indicated that the act was inadequate to enable the SEC to cope with the problem of scalping presented in the instant case. One year after the act was approved, a House report referred to it as "providing for the registration of investment advisers and in a small degree for the regulation of their activities."[27] Prior to the amendment of the act in 1960, a congressional report stated that "investment advisers are not now required to disclose the financial interest of affiliates in securities concerning which they give advice."[28] The same committee suggested that the act be amended to preclude an adviser from giving advice concerning a security in which he had an interest unless this interest was disclosed.[29] The SEC, in reference to a situation involving a factual pattern similar to the instant case, stated that it was unable to handle this problem properly.[30] Finally, the Senate report which accompanied the 1960 amendment mentioned a considered but unenacted provision which noted that its passage "would enable the Commission to deal adequately with such problems as material adverse interest in securities which the adviser is recommending to clients."[31] These factors indicated a lack of congressional intent to reach the problem presented by scalping.

24. Securities Act of 1933, § 17(a)(2), 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77q(a)(2) (1958).

25. SEC v. Capital Gains Research Bureau, Inc., 84 Sup. Ct. 275, 286 (1963). Mr. Justice Goldberg stated that since non-disclosure had become so ingrained in the concept of fraud in securities legislation, Congress must have deemed a specific prohibition against non-disclosure "surplusage."

26. Investment Advisers Act of 1940, § 206(3), 54 Stat. 852 (1940), as amended, 15 U.S.C. § 80(b-6)(3) (1958).

27. H.R. Doc. No. 246, 77th Cong., 1st Sess. 383 (1941).

28. H.R. Rep. No. 2711, 85th Cong., 2d Sess. 53 (1959).

29. *Id.* at 13.

30. The situation is described in H.R. Rep. No. 2711, 85th Cong., 2d Sess. 50-54 (1959). A registered adviser had, for several years, analyzed the stock of the Crowell-Collier Publishing Co. The adviser reported its findings to 15,000 subscribers. When Crowell-Collier sold an issue of debentures, an investment company, whose principal was also the president of the advisory service, purchased $200,000 principal amount of these debentures. The SEC stated that this "dual interest" did not constitute a specific violation of the act notwithstanding the fact that subscribers of the advisory service were not put on notice of the publisher's interest in the recommended security.

31. S. Rep. No. 1760, 86th Cong., 2d Sess. 8 (1960).

In the instant case, the Court liberally construed the Investment Advisers Act in an effort to maintain the general philosophy of disclosure underlying the federal securities legislation. No question was presented concerning the integrity or validity of the investment report itself and, therefore, no issue was raised of affirmative misrepresentations. Rather, the decision was predicated upon three reasons. First, the intent of the Investment Advisers Act was to preclude the *possibility* that an adviser might be motivated by any factors other than the best interests of his client. The Court's position was that if an adviser trades for his own account in recommended securities, there is the possibility that the advice he gives will be based upon self interest rather than the objective analysis which is required to serve the client properly. The necessary implication of this language is that the adviser's personal investment motivated the advice he subsequently rendered, rather than the more realistic approach that he was profiting on the expected market movements following his advice. It was the opinion of the Court that the client should be made aware of the possible conflict and then make his investment decisions. Second, there is a fiduciary relationship between an investment adviser and his client which imposes "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts'. . . ."[32] Third, fraud and deceit include omissions and concealments, and as applied to securities legislation, require neither proof of intent to injure nor actual injury.

It is submitted that in the instant case, the Court reached a desirable result. However, it is the writer's opinion that notwithstanding the broad scope and interpretation of other federal securities statutes, the language and history of the Investment Advisers Act was insufficient to sustain the decision. As previously noted, the Investment Advisers Act did not employ the "omission" terminology found in the Securities Act of 1933, which was the model for the Advisers Act. Moreover, Congress, even when presented with the specific problem of scalping, failed to take steps either to prohibit it or to require disclosure of the practice to clients. Since Congress had already expressed its policy with respect to the activities of investment advisers, the Court should have followed a position it recently announced in another securities case[33]—namely, that the process of statutory amendment is for Congress, not the Court.

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32. SEC v. Capital Gains Research Bureau, Inc., 84 Sup. Ct. 275, 284 (1963) citing PROSSER, TORTS § 87 at 534-35 (2d ed. 1955).

33. Blau v. Lehman, 368 U.S. 403 (1962).