Private Causes of Action Under Section 206 of the Investment Advisers Act

Michigan Law Review
NOTES

Private Causes of Action Under Section 206 of the Investment Advisers Act

Courts have frequently implied private causes of action under criminal or regulatory statutes to effectuate more fully the purposes of such statutes by encouraging citizen enforcement.1 Recently, two federal district courts,2 the first to have considered the issue carefully,3 reached conflicting conclusions whether to imply a private cause


The complaint in Gammage alleged violation of section 203(a)(5) of the Advisers Act, 15 U.S.C. § 80b-3(a)(5) (1970), as amended, 15 U.S.C.A. § 80b-3 (Supp. Aug. 1975), which gives the Commission enforcement powers over any investment adviser or "person associated with such investment adviser" who aids or abets the violation of any of the securities acts. The court declined to recognize an implied private cause of action for violation of this section. In reaching this decision, the court relied on
of action for damages for violations of section 206 of the Investment Advisers Act of 1940. That Act, administered by the SEC, was enacted for the purpose of eliminating the "questionable business methods" then prevalent among the investment advisory industry.

precedent. First, the court pointed to two circuit court cases, Brouk v. Managed Funds, Inc., 286 F.2d 901 (8th Cir. 1961), vacated as moot, 369 U.S. 424 (1962) (noted in 13 STAN. L. REV. 964 (1961)), and Kaufman v. Dreyfus Fund, Inc., 434 F.2d 727 (3d Cir. 1970), cert. denied, 401 U.S. 901 (1971), which it interpreted as denying private actions under the Advisers Act. Although unspecified violations of the Investment Advisers Act were alleged in Brouk, 286 F.2d at 902, the complaint primarily asserted violations of various sections of the Investment Company Act, and "[t]he court devoted its analysis to the Investment Company Act violations, apparently assuming that the Advisers Act provisions were inapplicable or too similar to warrant detailed consideration." 13 STAN. L. REV. 964, at 964 n.2. Kaufman was a class action brought by a shareholder of 4 mutual funds against 65 mutual funds and the Investment Company Institute. The plaintiff alleged violations of the Sherman and Clayton Acts, the Investment Company Act, the Securities Exchange Act, and section 206 of the Investment Advisers Act. 434 F.2d at 731-32. The court's decision to dismiss the plaintiff's complaint rested exclusively on the plaintiff's lack of standing to bring a direct class action against, or a derivative class action on behalf of, those mutual funds in which he did not have any ownership interest. See text at note 148 infra. Thus, neither Brouk nor Kaufman would seem to be the sort of firm precedent on which a court, faced with the problem whether to imply private causes of action, should rely.

Second, in dismissing the plaintiff's claim, the Gammage court relied on the Second Circuit's reasoning in Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir. 1966). However, the analogy drawn by the Gammage court between its facts and those of Colonial is not convincing. In Colonial the court was concerned with whether a private cause of action could be implied for violations of Exchange rules promulgated under the mandate of § 6 of the 1934 Securities and Exchange Act. The Colonial court relied on the fact that the statute itself depends on the exchange to sanction their own members for violations. Angelakis v. Churchill Management Corp., [Current Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,285, at 98,464 (N.D. Cal. June 6, 1975).


6. See note 73 infra and accompanying text. One commentator summarized some of the questionable practices as follows:

In 1939, it was not uncommon for an adviser to arrange that one client buy a certain security and that another sell the same one. Where the adviser operated on the then commonly accepted basis of receiving a proportion of profits made by his clients, he could not lose by using this technique. The adviser's sole concern was to seek new clients to replace those whose assets or credulity were exhausted. Adviser custody of clients' funds was the basis of most deceptive practices. Instead of buying and selling in the interest of the client there was frequently a shifting of high quality securities to the adviser's personal account and the placing of his unwanted issues in the client's account.


In its 1966 report to Congress on the investment industry in general, the SEC summarized the regulatory function of the Advisers Act as follows:
The Advisers Act, enacted as a companion to the [Investment Company] Act,
Within the reach of the Advisers Act are persons who “engage in the business” of investment advising or who, while principally engaged in some other business, receive “special compensation” for investment advice. Like other securities statutes, the Act requires registration with the SEC, prohibits fraudulent practices, and empowers the SEC to discipline violators. An investment adviser registered under the Act is subject to possible revocation or suspension of registration for “willful” misstatements or omissions in his application to register, for conviction of a felony or misdemeanor involving a securities transaction, for “willful” violation of a securities act, or for “aiding and abetting” the violation of a securities act. Section 206, one of the few substantive sections of the Advisers Act, is a

regulates the activities of those who receive compensation for advising others with respect to investments in securities or are in the business of issuing analyses or reports concerning securities. Like the Exchange Act, the Advisers Act requires those subject to its provisions to register with the Commission, prohibits fraudulent practices, and empowers the Commission to discipline violators of the statute and of its rules thereunder.


As originally enacted, section 203 of the Act excluded from registration an investment adviser whose only clients were investment companies. Investment Advisers Act of 1940, ch. 686, § 203(b)(2), 54 Stat. 850. Investment advisers excluded by this provision from registering under the Advisers Act were subject only to the regulations of the Investment Company Act, 15 U.S.C. §§ 80a-1 to -52 (1970), as amended, (Supp. IV, 1974); Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 1430. Investment fund advisers are now subject to the provisions of both acts. The present section 203 of the Advisers Act exempts, inter alia, all investment advisers whose only clients are insurance companies. Investment Advisers Act of 1940, § 203(b)(2), 15 U.S.C. § 80b-3(b)(2) (1970).


Registered investment advisers must also keep “such records, . . . and make . . . such reports, as the Commission . . . may prescribe as necessary or appropriate in the public interest or for the protection of investors.” Investment Advisers Act of 1940, § 204, 15 U.S.C.A. § 80b-4 (Supp. Aug. 1975).

13. 15 U.S.C. § 80b-6 (1970). Section 206 reads as follows:

It shall be unlawful for any investment adviser by use of the mails or any means or instrumentalities 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 oper-
general anti-fraud provision. Its language encompasses a broad range of adviser misconduct. Because of its breadth and its similarities with rule 10b-5 of the Securities Exchange Act, under which implied causes of action have been recognized since 1946, private plaintiffs seeking recovery under the Advisers Act have correctly viewed section 206 as the most logical provision upon which to base their claims.

ates as a fraud or deceit upon any client or prospective client;
(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction.

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices and courses of business as are fraudulent, deceptive, or manipulative.

14. The other major substantive provisions of the Advisers Act are section 205, 15 U.S.C. § 80b-5 (1970), which prohibits investment advisers from entering into certain fee arrangements with their clients and requires the adviser to get his client's consent before assigning the advisory contract; section 207, 15 U.S.C. § 80b-7 (1970), which makes it unlawful for any person "willfully" to make an untrue or misleading statement in any registration material filed pursuant to the Act; and section 208, 15 U.S.C. § 80b-8 (1970), which makes it unlawful for any person registered under the Act to imply that he is in any way "sponsored, recommended or approved" by the United States government, or to use the title "investment counsel" unless "a substantial part of his or its business consists of rendering investment supervisory services," or to do "indirectly" what it would be unlawful for such person to do "directly" under the Act. These three provisions can be said to "merge" into section 206. See 2 L. Loss, SECURITIES REGULATION 1412 (2d ed. 1961).


Most SEC actions taken pursuant to the Advisers Act over the past 35 years have also involved section 206. See references collected in 4 CCH FED. SEC. L. REP. ¶¶ 56,356-400. Prior to 1960, the SEC had little power to define and enforce violations of section 206. This lack of enforcement power led Professor Loss to characterize the Advisers Act as "little more than a continuing census of the Nation's investment advisers." 2 L. Loss, supra note 14, at 1393. In addition, the section was applicable only to registered investment advisers. See Investment Advisers Act of 1940, ch. 686, § 206, 54 Stat. 852. In 1960, section 206 was amended to give the SEC the power to "define, and prescribe means reasonably designed to prevent" violations of the section, and to cover all investment advisers, whether or not exempted from registration under the Act. Act of Sept. 13, 1960, Pub. L. No. 86-750, § 9, 74 Stat. 887. This latter change was intended to bring the Advisers Act in line with both the Securities and
This Note examines the propriety of implying a cause of action for damages under section 206. Upon concluding that such an implication is appropriate, it then suggests a scope for section 206 actions that implements the Act's underlying purposes.

I. THE IMPLICATION DECISION

Courts and commentators have devised a variety of theories for determining when courts should imply private causes of action for violations of federal regulatory and criminal statutes. In general, these theories have attempted to interpret and reconcile the few Securities Exchange Acts, which had established a pattern of extending anti-fraud provisions to nonregistered persons. See S. REP. No. 1760, 86th Cong., 2d Sess. 8 (1960).


Under the "statutory language" theory, a court will look to the language of the statute to find some legislative intent to grant a private right. The court using this approach is engaged in a form of statutory construction wherein it seeks to discover what the legislature "had in mind" when drafting the statute in question. See, e.g., Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) (finding grounds to imply a private right of action for violation of section 10(b) of the Securities Exchange Act from the provision of that act that states that "contracts in violation of any provision of the Act shall be void").

Under the "tort" theory of implied private causes of action, statutes that primarily provide criminal (or, in the case of the securities acts, federal agency) penalties, may be used by courts as a basis for determining what constitutes "the standard of conduct of a reasonable man," so long as it is found that the legislative purpose in enacting the statute was to protect persons in the plaintiff's position from the type of harm that allegedly resulted from the defendant's violation of the statute. See RESTATEMENT (SECOND) OF TORTS § 286 (1965). For a brief history of the tort theory of implied private causes of action, see 2 L. Loss, supra note 14, at 934-36.

Courts, for the most part, do not expressly adopt the statutory language or tort approach to the implication problem, but the two theories taken together do provide a framework for understanding how courts have dealt with the problem.

20. See, e.g., 2 L. Loss, supra note 14, at 943 (should ask whether there are any good reasons for not implying a private right); Ruder, supra note 19, at 643 (courts should look for "positive inference" of legislative intent); Note, 54 B.U. L. REV. 758, supra note 19, at 774-78 (private cause of action should be implied only when the act in question reflects a strong national policy); Note, Implied Civil Remedies Under Section 17(a) of the Securities Act of 1933, 53 B.U. L. REV. 70, 96 (1973) (implication may not be proper when act provides for an express private right elsewhere); Note, 77 HARV. L. REV. 285, supra note 19, at 295 (implication not proper when there is state law that pre-empts area or when there is an adequate administrative remedy); Note, Private Rights from Federal Statutes: Toward a Rational Use of Borak, 63 NW. U. L. REV. 454, 469 (1968) ("If an adequate remedy is available . . . either as to deterrence or compensation, a private right should be denied . . . ."); Comment, Private Rights and Federal Remedies: Herein of J. I. Case v. Borak, 12 UCLA L. REV. 1150, 1160-61 (1965) (implication may be proper when violations are very numerous and loss alleged is peculiar to plaintiff).
Supreme Court decisions dealing with the implication issue—decisions that, until recently, have left unclear the precise factors that must be present before the Court will imply a private cause of action.

For example, in *J. I. Case Co. v. Borak*, the Supreme Court implied a cause of action for damages in favor of corporate shareholders under the proxy provisions of section 14(a) of the Exchange Act. In reaching this result, the Court focused on two factors: legislative intent, gleaned from the jurisdiction provision of the Act, to grant such a cause of action and the need for private enforcement to “supplement ... Commission action.” Ten years later, in *National Railroad Passenger Corp. v. National Association of Railroad Passengers* (Amtrak), the Court refused to imply a cause of action for injunctive relief in favor of potential rail passengers under section 307(a) of the Rail Passenger Act of 1970 (the Amtrak Act). The Amtrak Court focused on three factors: legislative history, tenets of statutory construction, and the legislative purpose of the Amtrak Act. In the Court’s view, all three factors militated

21. See, e.g., cases cited in note 1 supra.
26. 377 U.S. at 432. The analysis in *Borak* has been subject to two principal criticisms. First, it has been said that *Borak*’s use of section 27 (the jurisdiction provision) of the 1934 Act to find legislative “intent” to imply a private cause of action under the Act is specious because
   
   . . . specific jurisdictional sections in federal statutes . . . merely indicate whether Congress intends federal courts to have exclusive or concurrent jurisdiction of actions arising under the statute. Without section 27 federal courts would have concurrent jurisdiction of suits under the Act by virtue of the “federal question” jurisdiction statute. Under that statute, the courts would have jurisdiction to decide whether a private right of action would not automatically result. An exclusive grant of jurisdiction should make no difference.

Note, 63 Nw. U. L. Rev. 454, supra note 20, at 461-62 (footnotes omitted). See also Comment, supra note 20, at 1161.

The second major criticism of the *Borak* decision is that the Court failed to articulate criteria for deciding when a private action should be implied as a “necessary supplement to Commission action.” See 397 U.S. at 433. It has been argued that without a clear indication of the “relative significance of deterrence and compensation,” it will be impossible for a court to know when a private right is necessary in a particular case. Note, supra, at 465-69.

28. 45 U.S.C. § 547(a) (1970). This section provides, in pertinent part: “If the Corporation or any railroad engages in . . . any action . . . inconsistent with the policies and purposes of this chapter . . . the district court of the United States . . . shall have jurisdiction . . . upon petition of the Attorney General of the United States or, in a case involving a labor agreement, upon petition of any employee affected thereby . . . to grant such equitable relief as may be necessary or appropriate . . . .” (Emphasis added.)
29. 414 U.S. at 458-61.
30. 414 U.S. at 458.
31. 414 U.S. at 461-64.
against implying a private cause of action for violations of section 307(a). Neither of these decisions made clear whether, before implying a private cause of action, a court must find express legislative intent to permit such an action, and neither made explicit how the various relevant factors (for example, legislative intent and legislative purpose) should be balanced.

In an effort to clarify the confusion generated by its prior decisions, the Supreme Court last term, in Cort v. Ash, outlined the framework within which the implication decision should be made:

In determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant. First, is the plaintiff "one of the class for whose especial benefit the statute was enacted," Texas & Pacific R. Co. v. Rigsby, 241 U.S. 33, 39 (1916) (emphasis supplied)—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? . . . Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? . . . And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?

Notwithstanding that in Cort v. Ash the Court denied the plaintiff's request for a cause of action, an examination of section 206 in light of these four factors clearly suggests that courts should imply private rights of action in favor of those injured by its violation.

A. The Class of Benefited Plaintiffs

In Cort v. Ash, the Supreme Court refused to imply a cause of action for damages in favor of shareholders of a corporation that had violated 18 U.S.C. § 610, a criminal statute prohibiting corporate contributions in connection with a presidential election. According to the Court, the protection of corporate stockholders was only a secondary purpose of the statute; its principal purpose was to derogate the influence over elections that corporations exercised through financial contributions. Thus, because the statute was not enacted

32. That the decisions in Borak and Amtrak generated confusion can best be seen by comparing the majority and dissenting opinions in Ash v. Cort, 496 F.2d 416, 421-23 (3d Cir. 1974), revd., 43 U.S.L.W. 4773 (U.S. June 10, 1975). The majority in Ash distinguished Amtrak and relied on Borak, inter alia, to imply a cause of action under 18 U.S.C. § 610. See 496 F.2d at 421-23. The dissent read Amtrak as a retreat from Borak's "liberal" position on implication, see 496 F.2d at 426-29, and thus would have denied a cause of action under section 610.
34. 43 U.S.L.W. at 4776.
35. 43 U.S.L.W. at 4776.
36. 43 U.S.L.W. at 4777.
for the "especial benefit" of stockholders, it conferred no federal right on the plaintiff class.

The first factor used in determining the propriety of implying a private cause of action, more clearly articulated in Ash than in prior decisions, is similar in purpose to the requirement of standing. Both serve to limit access to the courts to those individuals for whose benefit the statute was enacted, and, under each, the inability of one plaintiff to qualify does not necessarily preclude other plaintiffs from qualifying. While all statutes benefit or protect a class of individuals, all statutes do not confer an "especial benefit" or a federal right on any class. Similarly, because his interest is too diluted, a prospective plaintiff within a broad and amorphous class protected by a statute may fail to obtain standing to sue under that statute. It is doubtful, however, that the requirements are coterminous. The Court's use in Ash of the phrase "'for whose special benefit the statute was enacted,'" instead of the weaker phrase used in standing cases—"arguably within the zone of interests to be protected or regulated by the statute"—suggests that the former test is the more rigorous. Moreover, the plaintiff in Ash clearly needed standing to bring his suit. That the Court found it necessary nevertheless to set forth the "especial benefit" test further indicates that the Court was constructing a more difficult hurdle.

Section 206 of the Advisers Act was designed to protect investors in general, and clients and prospective clients of advisers in particular. While the exact limits of the benefited class are subject to dispute, it is clear that Congress intended to benefit a relatively specific group of individuals. In this regard section 206 is virtually identical to section 14(a) of the Securities Exchange Act, at issue in Borak, which was intended to protect corporate investors from management abuses of the proxy mechanism. By way of comparison, the provision considered in Cort v. Ash benefited the rather amorphous class of all citizens and voters; the provision considered in Amtrak indirectly benefited all potential rail passengers. Because violations of the provisions at issue in Ash and Amtrak could injure millions of individuals, public enforcement of those provisions seems desirable. Because violations of section 206 and of section 14(a) often damage only a small number of individuals, private enforcement of these provisions seems feasible. In short, the specificity of the class benefited by section 206 suggests that those clearly within

38. 43 U.S.L.W. at 4776.
40. See text at notes 140-46 infra.
41. See text at notes 140-65 infra.
the class should encounter few difficulties in satisfying this first requirement for the implication of a cause of action.

B. Legislative Intent

The presence of clear evidence of legislative intent either to create or deny a private cause of action is dispositive: Where evidence to deny exists, courts cannot fairly imply one, and where evidence to create exists, courts have a duty to implement that intent. In Amtrak, for example, the Court found explicit evidence that Congress intended the statutory remedy to be exclusive. The legislative history of the Amtrak Act revealed that a proposal to re-draft section 307(a) "so as to provide that any aggrieved party . . . could institute legal proceedings for violations of the law," was rejected by the House committee after the Secretary of Transportation objected to the proposal.\textsuperscript{43} Of course, legislative intent can be implicit as well as explicit. One technique courts have employed to discern implicit intent is to infer from the inclusion of a private remedy in one provision of a statutory scheme a legislative intent to preclude private remedies for other provisions.\textsuperscript{44} In Ash, however, the Court summarily discredited this method of deriving legislative intent. A valid inference that the sought-after remedy has been precluded, the Court noted, arises only when, under the provision at issue rather than some other provision, plaintiff has some method for obtaining his desired relief.\textsuperscript{45} Finally, and perhaps most commonly, evidence of legislative intent may be absent. The Court in Ash made clear that, when this is the case, courts can imply causes of action if appropriate in light of the other three factors.\textsuperscript{46}

There is no explicit evidence in the reported legislative history of section 206 that Congress considered the issue of private causes of actions for damages under that section. In Borak, the Court found evidence of congressional intent implicit in the jurisdiction provision of the Securities Exchange Act;\textsuperscript{47} it is therefore appropriate to examine the jurisdiction provision—section 214—of the Investment Advisers Act, which reads in pertinent part: "The district courts of the United States . . . shall have jurisdiction of violations of this subchapter or the rules, regulations, or orders thereunder, and, concur-


\textsuperscript{44} See Ash v. Cort, 496 F.2d 416, 426-29 (3d Cir. 1974) (Aldisert, J., dissenting), revd., 43 U.S.L.W. 4773 (U.S. June 17, 1975). The remedy provided plaintiff under the Amtrak Act was to petition the Attorney General to bring suit for an injunction under the Act.

\textsuperscript{45} 43 U.S.L.W. at 4778 n.14.

\textsuperscript{46} 43 U.S.L.W. at 4778.

\textsuperscript{47} 377 U.S. at 431.
rently with State and Territorial courts, of all suits in equity to enjoin any violation of this subchapter or the rules, regulations, or orders thereunder. 48

In Greenspan v. Campos del Toro, 49 one of the two decisions to consider carefully the propriety of a private damage action under section 206, the court compared section 214 with the jurisdiction-conferring provisions of the Securities Exchange Act 50 and the Investment Company Act, 51 both of which provide that district courts shall have jurisdiction “of all suits in equity and actions at law” brought to enforce any liability created by the Act. 52 The court concluded that because the words “actions at law” were omitted from section 214, it could entertain requests under section 206 for equitable relief only. It therefore dismissed plaintiff’s damage action for lack of subject matter jurisdiction. 53

Jurisdiction, or the power to hear a suit, and the propriety of implying a private cause of action, are issues easily confused. 54 The omission of “actions at law” from section 214 could mean either that section 214 does not grant federal courts the power to hear damage actions under the Advisers Act 55 or that Congress intended to preclude the implication of damage actions for violations of the Act. 56


The Greenspan court perhaps believed that the difference in the jurisdictional statutes amply distinguished Borak. Although the Borak Court saw the jurisdiction section of the 1934 Act as evidence of legislative intent, see 377 U.S. at 433-34, the decision did not rest on this alone. The Court’s examination of the purpose behind the enactment of section 14(a) was equally important to the outcome in that case. See Note, 63 Nw. U. L. Rev. 454, supra note 20, at 460.


In this Court and in the Court of Appeals, the parties have approached the question from several perspectives. The issue has been variously stated to be whether the Amtrak Act can be read to create a private right of action to enforce compliance with its provisions; whether a federal district court has jurisdiction under the terms of the Act to entertain such a suit; and whether the respondent has standing to bring such a suit. Because the reference in each instance is to § 307(a) of the Act and the legislative history behind that provision, these questions overlap in the context of this case even more than they ordinarily would.

56. The accountant-defendants in Bolger v. Laventhol, Krekstein, Horwath & Horwath, 381 F. Supp. 260 (S.D.N.Y. 1974), argued that “t]he failure to include any reference to ‘actions at law’ can only be interpreted as expressly prohibiting damage actions under the Advisers Act.” Reply Memorandum of Defendant Laventhol, Krekstein, Horwath & Horwath at 4-5.
The Greenspan court apparently adopted the first interpretation. The court failed to realize, however, that this interpretation does not resolve the implication question since it leaves federal courts free to assert jurisdiction under the general federal question or diversity of citizenship statutes: once jurisdiction is obtained, a court must then decide the propriety of implying a cause of action. Arguably, section 214 is an exercise by Congress of its power to limit the jurisdiction of federal courts and precludes courts from asserting jurisdiction under any jurisdiction statute. Courts have shown extreme reluctance, however, to conclude that Congress has exercised this power and have done so only in the face of clear evidence of congressional intent.

Because no such evidence underlies section 214, a court following the Greenspan interpretation of that section must still determine whether Congress intended to preclude damage actions for violations of the Adviser's Act.


61. The court in Bolger v. Laventhol, Krekstein, Horwath & Horwath, 381 F. Supp. 260 (S.D.N.Y. 1974), makes the point that it is possible to read section 214 so as to confer jurisdiction on federal district courts for damage claims brought under the Act. Relying on an earlier New York district court opinion, Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949), the Bolger court concluded that "defendants' argument overlooks the language of Section 214 which confers jurisdiction over 'violations' of the statute and the rules promulgated thereunder. . . . The term 'violations' is not limited to criminal proceedings . . . . It is therefore broad enough to confer jurisdiction on the district courts for an implied damage action such as the instant suit." 381 F. Supp. at 264 (emphasis original).

In Osborne, the complaint alleged violations of section 17 of the Securities Act of 1933, and sections 10(b) and 15(c) of the Securities Exchange Act of 1934. Defendant moved to dismiss for failure to state a claim on which relief could be granted. The court, in sustaining the section 10(b) claim, pointed to the language of section 27 of the 1934 Act giving federal courts jurisdiction over "violations of this chapter," and then said, "[t]he word 'violation' is not limited to a criminal case; it includes also civil litigation." 86 F. Supp. 869 at 879. The language of section 27 of the Securities Exchange Act contains the "at law" reference, however. See 15 U.S.C. § 78aa (1970). The Osborne court thus merely determined that civil actions "at law or equity" were equally cognizable with criminal actions "at law or equity" under that act. The Bolger court overlooked the limited nature of the Osborne holding. Reading the word "violations" in section 214 of the Advisers Act so as to include civil violations as well as criminal violations does not circumvent the problem of the absence of the "at law" language in this section. Read literally, construing "violations" to mean both civil and criminal violations, the section confers federal jurisdic-
As pointed out in Bolger v. Laventhol, Krekstein, Horwath & Horwath, the second decision considering section 206 damage actions, the legislative history of the Advisers Act contains no evidence that Congress intended to differentiate section 214 from the jurisdictional provisions of other securities legislation. The only reference to section 214 can be found in a passage of the Senate report that comments on the enforcement provisions of the Act in general; it states that they are "generally comparable" to those of the Investment Company Act, the jurisdiction section of which contains the "at law" language. This comparison negates any inference from section 214 that, by omitting the "at law" language, Congress explicitly intended to preclude damage actions under the Advisers Act.

Other methods of deriving implicit legislative intent yield equally inconclusive results. Section 215(b) of the Advisers Act provides that "[e]very contract made in violation of any provision of this subchapter . . . shall be void . . . . " The court in Kardon v. National Gypsum Co. viewed a similar provision in the Securities Exchange Act as affirmative evidence of congressional intent to allow private parties to assert claims under that Act. While such an inference from section 215 is possible, it is arguably offset by indications in the Act's legislative history of congressional reluctance to "over-regulate" the advisory industry, which suggest a desire to

63. 381 F. Supp. at 264.
64. S. REP. No. 1775, 76th Cong., 3d Sess. 23 (1940).
69. It is clear that, as enacted, the Investment Advisers Act represented a compromise between the SEC and the investment advisory industry. See S. REP. No. 1775, supra note 64, at 20-21. In the congressional debate over the passage of the Advisers Act, concern over weaknesses in the regulatory aspects of the Act, such as the exemption from registration for lawyers, accountants, and teachers who give investment advice only "incidentally" to their main business, § 202(a)(11)(B), 15 U.S.C. § 80b-2(a)(11)(B) (1970), and the lack of any educational or professional requirements for registration under the Act, was voiced. See 86 CONG. REC. 9814 (1940) (remarks of Representative Hinshaw). Because there was strong congressional feeling that both the investment company and investment advisory industries were essential to the national economy and should not be jeopardized, see 86 CONG.
minimize the potential liability of advisers. In sum, there is neither explicit nor implicit evidence of congressional intent to create or deny a cause of action for damages under section 206.

C. Legislative Purpose

Like the other securities acts, the Investment Advisers Act is both "remedial" and regulatory; its principal purpose is the encouragement of investment by providing adequate protection against fraudulent manipulations by dishonest advisers. The relevant report of the Senate Committee on Banking and Currency states: "The nature of the functions of investment advisers, their increasing widespread activities, their potential influence on security markets and the dangerous potentialities of stock market tipsters imposing upon unsophisticated investors, convinces this committee that protection of investors requires the regulation of investment advisers on a national scale." In 1940 Congress was particularly concerned with the state of the economy; industry in general and the defense industry in particular needed the financial impetus that private investment could provide. Following the stock market crash of 1929, the public had become increasingly cautious about investing without professional consulta-

---

72. See note 6, supra, for examples of advisory industry practices that led to the enactment of the Investment Advisers Act.
73. S. REP. No. 1775, supra note 64, at 21. See also H.R. REP. No. 2639, 76th Cong., 3d Sess. 28 (1940): "The essential purpose of [the Advisers Act] is to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful."
74. The congressional reports accompanying the Investment Company Act of 1940, title 1 of the bill of which the Advisers Act was title II, are illuminating in this respect. The Senate report states: "Finally, a most significant function of investment companies in relation to the immediate needs of the national economy is their potential usefulness in the supply of new capital to industry, particularly to small and promotional ventures. . . . It is the hope of the committee . . . that regulation of investment companies, as provided for in this bill, may stimulate venture capital and the financing of industry." S. REP. No. 1775, supra note 64, at 5. The House report adds: "[P]roper and reasonable regulation of investment companies may substantially stimulate investment companies to supply new capital for the expansion of industry, particularly industries vital to the national defense . . . ." H.R. REP. No. 2639, supra note 73, at 5.
tion.\textsuperscript{75} Aware of and seeking to protect the "fiduciary nature" of the relationship between adviser and client,\textsuperscript{76} Congress passed the Advisers Act with the aim of "substitut[ing] a philosophy of full disclosure for the philosophy of \textit{caveat emptor} and thus . . . achiev[ing] a high standard of business ethics in the securities industry."\textsuperscript{77}

Given these underlying purposes, the implication of a private cause of action under section 206 is appropriate. First, it is obvious that section 206 is similar to section 14(a) of the Exchange Act, considered in \textit{Borak}. Both provisions protect investors by proscribing certain manipulative practices and both are ostensibly enforced by the SEC. In \textit{Borak}, the Court implied a cause of action for damages;\textsuperscript{78} the same result seems warranted under section 206.

Second, the remedies expressly provided in the Advisers Act for violations of its provisions are insufficient to accord full relief to injured clients and are by no means frustrated by the implication of a cause of action for damages. Section 206(4) of the Advisers Act\textsuperscript{79} grants the SEC the power to define and "prescribe means reasonably designed to prevent" fraudulent, deceptive and manipulative acts for the purpose of determining what constitutes a violation of that provision.\textsuperscript{80} The Commission's enforcement powers, set forth in section 203(e),\textsuperscript{81} are in general limited to denying registration to, revoking or suspending the registration of, placing limitations on the activities of, or "censuring"\textsuperscript{82} an investment adviser who violates the Advisers Act, "if it finds . . . that such censure, denial, placing of limitations, suspension, or revocation is in the public interest."\textsuperscript{83} The Commission is given full "investigative" powers under the Act, "[w]henever it shall appear to the Commission, either upon complaint or other-

\textsuperscript{75} See Comment, supra note 6, at 69.


\textsuperscript{78} The \textit{Borak} Court found that the "protection of investors" language in section 14(a) "implies the availability of judicial relief where necessary to achieve that result." 377 U.S. at 432.

\textsuperscript{79} For the text of this provision, see note 13 supra.

\textsuperscript{80} For a discussion of how the SEC has interpreted section 206, see text at notes 107-35 infra.


\textsuperscript{82} Section 206 was amended in 1960 to apply to all investment advisers, whether registered under the Act or not. See note 18 supra. Until the 1975 amendment to the Act that added the phrase "placing limitations on the activities of," Commission "censure" was the only form of enforcing the prohibitions of section 206 against unregistered advisers, aside from possible imposition of criminal penalties. The Commission also uses the more lenient "censure" device against advisers who have violated the Act when it finds "mitigating circumstances"—usually an attempt by the adviser to make good his wrong. See, e.g., Axe Securities Corp., 42 S.E.C. 381, 384 (1964).

wise, that the provisions of [the Act] or of any rule or regulation prescribed under the authority thereof, have been or are about to be violated by any person.\textsuperscript{84} The Commission may, “in its discretion,” bring a district court action to enjoin violations of the Act, or it may transmit evidence of such a violation to the Attorney General, “who, in his discretion, may institute the appropriate criminal proceeding.”\textsuperscript{85}

Thus, the only remedy provided by the Act to investors who are injured by the fraudulent acts of their advisers is to file a complaint with the SEC and await Commission action.\textsuperscript{86} While in Amtrak the Court found a similar remedy\textsuperscript{87} sufficiently effective to implement the purposes of the Amtrak Act,\textsuperscript{88} the situation of the plaintiff passenger association in that case is clearly distinguishable. First, the principal purpose of the Amtrak Act was not to protect the plaintiffs. Second, the plaintiff in Amtrak sought a remedy—an injunction halting a proposed rail line discontinuance—already provided by the Act, although in a less direct manner. Finally, there existed clear evidence that Congress intended the statutory remedy to be exclusive. On the other hand, the principal purpose of the Advisers Act is to protect investors, plaintiffs asserting a damage claim under section 206 seek a remedy not provided by the Act, and there is no evidence that Congress wanted the statutory remedy to be exclusive.\textsuperscript{Cort v. Ash} is also of little guidance, for there the remedy sought was one traditionally provided by state corporation laws. From this fact, the Court inferred that Congress intended to leave the remedy to the discretion of the states.\textsuperscript{89} Because the regulation of investment advisers is predominated by federal supervision,\textsuperscript{90} such an inference in the context of section 206 is unreasonable.

Finally, the implication of a cause of action for damages under section 206 protects investors more fully. In\textsuperscript{Borak}, the Court

\textsuperscript{88} 414 U.S. at 464.
\textsuperscript{89} 43 U.S.L.W. at 4778.
\textsuperscript{90} \textit{See} text at notes 102-05 infra.
supported its implication of a damage action by noting the inability of the SEC to examine carefully all of the proxy statements it received\(^9\) and by noting the deterrent value of private damage actions.\(^8\) Similarly, the SEC cannot supervise and investigate the activities of all advisers, and section 206 private damage actions would doubtless encourage compliance.\(^9\) Both Congress\(^8\) and the SEC\(^6\) have voiced concern over the adequacy of enforcement of the Advisers Act. Allowing private plaintiffs to sue under section 206 would serve to “supplement” SEC enforcement and thus would aid the SEC in “maintaining the confidence of the public in the processes of capital formation and securities trading.”\(^7\) Such private actions would also serve to compensate plaintiffs for what oftentimes are egregious losses—an result consistent with that of many recent cases adopting a liberal approach toward allowing recovery under various provisions of the securities acts.\(^8\) Any concern over subjecting investment advisers to undue liability that stems from the fact that Congress has never seen fit to regulate the day-to-day activities of advisers can be accommodated by carefully “shaping” the right of action under section 206, rather than by denying it altogether. In sum, the implication of a private cause of action for damages under section 206 would be consistent with, and in fact would further, the underlying purpose of the Act.

---

91. 377 U.S. at 432.
92. 377 U.S. at 432.
93. The SEC is empowered to investigate advisers only after it has reason to believe that the Act has been or is about to be violated. Investment Advisers Act of 1940, § 209(a), 15 U.S.C. § 80b-9(a) (1970). Knowledge of possible civil damage liability would undoubtedly have a stronger deterrent effect than would knowledge that, if the violation is brought to the attention of the SEC, that agency may then begin to investigate.
94. See S. Rep. No. 1760, supra note 18, at 4: “A major concern of the bill [to amend the Investment Advisers Act] is to aid the Commission in enforcing compliance with the act. There are at present over ½ million individuals in the United States who own corporate securities, nearly double those in 1952 . . . . [T]his new group offers strong temptation to confidence men and swindlers who may give them biased advice or misuse their funds or securities.”
95. See SEC Report, supra note 6, at 345-46.
D. State Law

The final factor set forth in Ash is whether the cause of action is one traditionally relegated to state law and in an area in which state law predominates. In Cort v. Ash, plaintiff stockholders sought to require defendant corporate directors to repay corporate funds illegally expended on a presidential election. The Court found significant the fact that state law regulates the relationships between shareholders, corporations, and corporate directors, and provides methods for shareholders to remedy director actions that are ultra vires. Because the area was pervaded by state law and not one traditionally the subject of federal regulation, this factor in Ash militated against the implication of a federal cause of action.

State law in the context of investor/advisor relations is and traditionally has been sparse. Although twenty-seven states now have anti-fraud statutes that deal specifically with the dispensing of investment advice, most of these statutes have only recently been enacted and only one expressly provides for a civil cause of action against fraudulent investment advisers. Moreover, federal regulation has served as a model in this area, and thus has not infringed upon extant statutory schemes: The bulk of these statutes are fashioned after section 102 of the Uniform Securities Act, whose language in turn is taken from sections 206(1) and (2) of the Advisers Act. Thus, because the implication of a federal cause of action would not conflict with long-established state laws or state interests, this factor does not counsel against judicial implication of a damage action.

99. See text at note 34 supra.
100. 43 U.S.L.W. at 4775.
101. 43 U.S.L.W. at 4778.
105. UNIFORM SECURITIES ACT § 102, Comment .01.
II. THE SCOPE OF THE CAUSE OF ACTION

As one commentator has stated with regard to private causes of action under section 14(a) of the Securities Exchange Act: "It does not follow [from the implication of a cause of action] that every minor infraction of the proxy rules—such as mailing to the Commission only three rather than four copies of the annual report—will automatically invalidate the proxies."\(^{106}\) Nor need it follow from the implication of a cause of action under section 206 that all violations of that section will subject advisers to private damage liability. In exercising their discretion, federal courts should tailor the cause of action under section 206 to effectuate the principal purpose of the Advisers Act—the preservation of the fiduciary relationship between advisers and investors.

This section proposes a scope for damage actions under section 206; first, it outlines the substantive content of section 206 as interpreted by the SEC and enforced by the courts, and then, in light of the purpose of the Act, delineates the damage action by defining classes of plaintiffs and defendants, and establishing standards of causation and scienter.

A. Substantive Content of Section 206

The SEC has broad definitional and rulemaking powers under section 206 and has used those powers to describe practices it considers "fraudulent," "manipulative," or "deceptive" within the meaning of that section. Because of the SEC's familiarity with the problems of investors and the practices of advisers, federal courts should give weight to these substantive interpretations. However, because the adverse consequences to the advisory industry of subjecting investment advisers to damage liability may be far greater than the adverse consequences of subjecting them to agency disciplinary proceedings,\(^{107}\) courts should reject SEC interpretations where appropriate to further legislative intent.

For convenience, the SEC interpretations discussed here are divided into three groups: conduct involving misrepresentation or nondisclosure, conduct not involving misrepresentation or nondisclosure that is nevertheless fraudulent or deceptive, and conduct involving adviser/client fee arrangements (which may or may not fit into either of the other categories).

1. Misrepresentation and Nondisclosure

Adviser advertising is one area in which the SEC has frequently

\(^{106}\) 2 L. Loss, supra note 14, at 943.

found nondisclosure or misrepresentation. Rule 206(4)-1108 prohibits an investment adviser from including in advertising material (1) testimonials by former clients, (2) past specific recommendations made by the adviser unless the advertisement offers to supply the potential client with a list of all recent recommendations, (3) graphs, charts, or other formulae that purportedly aid the client in making investment decisions unless the advertisement "prominently discloses" the limitations and difficulties of using such formulae, (4) any offer of "free" services to clients unless the services are indeed free, and (5) any statements that are false or misleading.109

The SEC has also determined that section 206 is violated by misrepresentations and nondisclosure in advisory publications and direct statements to clients.110 In particular, the SEC has found violations of section 206 in the publication of misleading statements about the background and experience of the adviser111 or the corporations in which the adviser has urged his clients to invest,112 in the making of false and deceptive statements to clients about the price at which they could purchase certain stock,113 and in the failure to disclose to clients to whom notices of the assignment of their advisory contracts were sent that the contracts could not be assigned without their consent.114

Finally, the Commission has found nondisclosure or misrepresentation violative of section 206 in the area of adviser conflicts of interest. Under section 206(3), any adviser acting as a principal for his own account (or acting as a broker for another client's account)


109. For applications of the rule see, for example, Killigore Management, Inc., [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,977 (SEC Aug. 25, 1972) (rule violated by advertisement failing to disclose that securities listed in sample portfolio were arbitrarily selected and showed fortuitous profits and losses); Shortline Reports, Inc., [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,962 (SEC Feb. 22, 1971) (false, misleading, deceptive, flamboyant, and excessively dramatic newspaper advertisements); Axe Securities Corp., 42 S.E.C. 381 (1964) (violation where not disclosed that adviser paid for article appearing in book distributed to prospective brides that described adviser as "outstanding" and "nationally recognized").


who sells or purchases a security to or from a client must disclose his interest and obtain the client’s consent before effecting the transaction.\textsuperscript{115} The SEC has maintained:

The disclosure should include, as a minimum, (a) the capacity in which the investment adviser proposes to act, (b) the cost to the adviser of any security which he proposes to sell to his client (or, if he proposes to buy a security from his client and knows or is reasonably certain of the price at which it is to be resold, a statement of that price), and (c) the best price at which the transaction could be effected by or for the client elsewhere if such price is more advantageous to the client than the actual purchase or sale price. Moreover, any disclosure of the cost to the investment adviser (or the price he expects to receive on resale) should be so phrased that its full import is obvious to the client.\textsuperscript{116}

Section 206(3) is principally aimed at adviser “scalping”—that is, purchasing stock prior to recommending it to clients and then selling it after the market has shifted due to the adviser’s recommendations. In 1963, in \textit{SEC v. Capital Gains Research Bureau, Inc.},\textsuperscript{117} the Supreme Court held that the SEC could obtain an injunction requiring advisers to make full disclosure of the practice to clients. On the basis of the legislative history of the Investment Advisers Act, the Court concluded that the Act “reflect[ed] a congressional recognition ‘of the delicate fiduciary nature of an investment advisory relationship.’”\textsuperscript{118} Although the Court refused to conclude that section 206 prohibits all trading by an investment adviser in securities in which his clients have an interest,\textsuperscript{119} the SEC has used the Court’s reasoning to revoke the registration of an adviser who engaged in “scalping” at a loss: “Even though the shares were sold at a loss, the recommendation by [the investment adviser] of a stock in which [its president] was trading without revealing his personal interest in that stock constitutes fraudulent conduct.”\textsuperscript{120}

2. \textit{Fraudulent and Deceptive Practices}

While emphasizing nondisclosure and misrepresentation, the SEC has decided that certain adviser practices are prima facie violations of section 206 notwithstanding full disclosure to clients. In this category are various arrangements between investment advisers and broker-dealers: (1) the interpositioning, by an adviser, of a broker-dealer between a mutual fund and a second broker-dealer who actually

\textsuperscript{115} For the text of this provision, see note 13 \textit{supra}.


\textsuperscript{117} 375 U.S. 180 (1963).

\textsuperscript{118} 375 U.S. at 191, \textit{quoting} 2 L. Loss, \textit{supra} note 14, at 1412.

\textsuperscript{119} 375 U.S. at 196.

\textsuperscript{120} Patrick Clements, 42 S.E.C. 373, 379 (1964).
effects the fund’s transactions,121 (2) an arrangement between a broker-dealer and an investment adviser whereby the adviser “recapture[s]” part of the commission paid by the adviser’s clients to the broker-dealer,122 (3) an arrangement whereby a broker-dealer receives part of the fee paid by a client to his investment adviser in return for recommending the adviser to the client and performing certain services for the adviser,123 and (4) an arrangement whereby an investment adviser directs individual portfolios that he manages to a broker-dealer in return for credit against subscription or equipment expenses.124

The SEC has also ruled that certain adviser/client agreements are prima facie violations of section 206. One ruling involved a “Memorandum of Agreement” sent by the advisor to each of her clients. The memorandum stated that the adviser would act as principal in all transactions involving her clients’ accounts unless otherwise agreed. The District of Columbia Circuit affirmed the SEC’s revocation of the adviser’s registration in this instance notwithstanding an amicus brief, urging reversal, filed by 120 of the adviser’s 175 clients.125 In another ruling,126 the SEC concluded that section 206 would be violated by an “earnest money” agreement entered into between an adviser and a prospective client whereby the adviser would credit the prospective client’s deposit against future adviser’s fees but keep the deposit if no advisory contract were ultimately signed.

The list of prima facie violations of section 206 also includes most adviser dealings in client funds. Rule 206(4)-2127 prohibits any adviser “who has custody or possession of any funds or securities in which any client has any beneficial interest” from taking any action with respect to those funds or securities unless (1) the securities are segregated, identified, and kept in a reasonably secure place, (2) the

---

122. Provident Management Corp., 44 S.E.C. 442 (1970). The SEC found this practice to be violative of section 206 despite the fact that no injury to the adviser’s client had been shown: “While there is no proof that Fund [client] did not receive the best execution on its transactions, or that the existence of the arrangements described resulted in additional costs to Fund, once the reciprocal arrangements were made, it was improper for [the adviser] to keep for itself rather than confer on Fund the benefits attributable to Fund’s assets.” 44 S.E.C. at 447.
funds are kept in a separate bank account maintained in the adviser's name as trustee and the adviser keeps separate records of each account, (3) the adviser gives written notice to his clients as to where the funds or securities are kept, (4) the adviser sends an itemized record of such funds or securities to each client at least once every three months, and (5) all funds are verified at least once each year by an independent public accountant, without prior notice to the adviser, and a copy of the accountant's certificate is filed with the SEC.

3. Fee Arrangements

The SEC has proscribed under section 206 certain adviser/client fee arrangements. In this area, the Commission has relied principally on findings of nondisclosure and misrepresentation but has suggested as well that, with regard to unsophisticated or naïve investors, no amount of disclosure will suffice. In the case of fees charged for advisory services, the SEC has determined that any adviser desiring to charge more than "the normal fee charged by the advisory industry" must "disclose to existing and potential clients not only that its fee is higher than normal, but the extent to which its fee is higher than normal." Generalizing, the Commission has stated:

[Whether or not a particular act, practice or course of business would operate as a fraud on a client is a question of act [sic]. Accordingly, whether or not the Adviser's disclosure with respect to fees would be adequate in a particular case would depend on the totality of the circumstances in which such disclosure is made including the manner in which it is made, and the sophistication of the particular client.]

Two statutory provisions in the investment area that expressly regulate compensation agreements shed light on the content of section 206. Section 205 of the Investment Advisers Act prohibits registered investment advisers from entering into or performing under an investment advisory contract that, inter alia, "provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client." This section is inapplicable to advisers exempt from registration under the Act, to advisory contracts between an adviser

and an investment company registered under the Investment Company Act, and to contracts "relating to the investment of assets in excess of $1 million." According to Professor Loss, section 205 "merges" with section 206 so that conduct violative of section 205 is "fraudulent" and "deceptive" within the meaning of section 206.

Section 36(b) of the Investment Company Act, added in 1970, provides an express cause of action in favor of clients of investment company advisers who "breach [their] fiduciary duty" in the setting of advisory fees. Presumably, conduct proscribed by section 36(b) also would be actionable under section 206. The cause of action set forth in section 36(b), however, is circumscribed in some very important respects: Suit may be brought only against the investment adviser, recovery may not be had for damages sustained more than one year before the institution of the action, and damages are limited to the amount of compensation received by the adviser.

To assure that these congressionally imposed limitations on the section 36(b) cause of action are not circumvented, courts could exclude excessive fee arrangements from the reach of section 206, or they could apply the section 36(b) limitations to all suits under section 206 involving adviser fees. A third and more appropriate alternative, however, would be to apply the section 36(b) limitations only to suits under section 206 brought against advisers who are also within the reach of the Investment Company Act. The first alternative is unnecessarily cautious. While dealing with all advisers uniformly, the second alternative is less attractive than the third because it fails to maximize client recovery of legitimate damages and because it applies limitations on the cause of action outside of the narrow context in which those limitations were considered by Congress.

4. The Rationale: Adviser as Fiduciary

Underlying these SEC applications of section 206 is the idea that investment advisers are fiduciaries and as such are charged with the obligations and responsibilities of dealing in utmost good faith. This viewpoint, supported by the Act's legislative history and by the

133. 2 L. Loss, supra note 14, at 1412.
Supreme Court’s decision in *Capital Gains*, should be adopted by courts in constructing a section 206 private cause of action.

The focus on the fiduciary nature of the adviser/client relationship differentiates section 206 from, for example, rule 10b-5, which is aimed at eliminating nondisclosure and misrepresentation rather than at preserving a fiduciary relationship. While full disclosure of a transaction usually absolves individuals of 10b-5 liability, a sufficiently unfair transaction should give rise to section 206 liability notwithstanding the disclosure, so long as the requisite causation is established. One decision in which the court failed to notice this significant difference between section 206 and rule 10b-5 is *Jones Memorial Trust v. Tsai Investment Services, Inc.* There, plaintiffs alleged that mismanagement by an investment adviser of the “process of research and recommending investment transactions” violated both provisions. Lumping the provisions together, the court concluded that, since the alleged mismanagement was fully disclosed, neither provision was violated. This result seems improper if the section 206 private cause of action is to protect the fiduciary nature of the adviser/client relationship and proscribe substantive as well as procedural unfairness.

### B. The Plaintiff Class

In light of the Supreme Court’s decision in *Cort v. Ash*, it is clear that the question of who can sue under section 206 is answered by applying the traditional test for standing and by discerning from the substance and legislative history of the Advisers Act the intended beneficiaries of section 206. These two inquiries overlap (the standing determination whether a prospective plaintiff is within a statute’s zone of interest is subsumed in the determination whether he is within the class for whose especial benefit the statute was enacted) and thus merge into a twofold test: has the plaintiff suffered injury in fact, and does he satisfy the *Ash* “especial benefit” test. Since the first half of the test is basically a question of fact, the determination of who can sue under section 206 turns on the second half of the test. This section isolates the class for whose especial benefit the Advisers Act in general and section 206 in particular were enacted.

Sections 206(1) and (2) of the Advisers Act make it unlawful for an investment adviser to engage in any act that operates as a fraud upon any client or prospective client. Section 206(3) speaks of the relationship between the adviser and client. Section 206(4), on the other hand, omits the client/prospective client language and makes

---

139. 367 F. Supp. at 497.
unlawful all fraudulent conduct, as that term is defined by the SEC. The specific language in sections 206(1), (2), and (3) suggests that clients and, in some cases, "prospective clients"\textsuperscript{140} of advisers are the intended beneficiaries of section 206 and should be able to bring private damage suits under that section. The question remains, however, whether any person who suffers financial injury as a result of an adviser’s violation of section 206 should have access to the section 206 cause of action.

Limitation of the section 206 cause of action to clients or prospective clients of investment advisers would exclude from recovery a potentially large class of individuals injured by violations of the section. This class would include persons who were essentially "tippees" of the adviser’s clients—that is, persons who received and relied on to their detriment incomplete or inaccurate information promulgated by an adviser and relayed by one of the adviser’s clients. The class would also include members of the public at large who, for example, while not themselves "subscribers," read an advisory publication containing false information and suffered subsequent economic loss in reliance upon that information.\textsuperscript{141} If the primary function of section 206 private causes of action is either the deterrence of all fraudulent conduct by advisers or the compensation of all losses flowing from violations of section 206, then it seems desirable to extend the action to these potential plaintiffs. If the purpose behind constructing a private cause of action is viewed more restrictively, however, as preserving and protecting a specialized relationship of trust between adviser and client, then the exclusion of nonclients from suit under section 206 seems appropriate.

There are several reasons for a court to adopt the more restrictive stance in determining the plaintiff class for section 206 actions. As noted above,\textsuperscript{142} the SEC has characterized investment advisers as fiduciaries and has defined the scope of their obligations under section 206 in terms of "fiduciary duties." The principle that accords substantial weight to the interpretation of a statute by the department entrusted with its administration\textsuperscript{143} therefore counsels courts to limit

\begin{enumerate}
\item The meaning of the term "prospective client" is discussed in the text at and following note 156 \textit{infra}.
\item It is difficult to think of a violation of section 206 not involving misrepresentation or fraudulent omission for which a nonclient could maintain an action under that provision, assuming that courts demand some showing that the adviser’s violation caused plaintiff’s injury.
\item See note 136 \textit{supra} and accompanying text.
\item "[I]t has long been established that the question of the inclusion of a particular person or entity within the coverage of a regulatory statute is generally for initial determination by an agency, subject to review on direct appeal, rather than for a district court. . . ." SEC \textit{v. Wall St. Transcript Corp.}, 422 F.2d 1371, 1375 (2d Cir.), \textit{cert. denied}, 398 U.S. 958 (1970). \textit{But cf. Townsend v. Swank}, 404 U.S. 282, 286 (1971) (principle inapplicable when agency regulations conflict with statute).
\end{enumerate}
the scope of the adviser's liability to those persons to whom fiduciary duties are owed. Injury to persons other than clients and prospective clients, while perhaps foreseeable from the point of view of the deceptive investment adviser, cannot be said to flow from the breach of a fiduciary duty owed to the injured nonclients without expanding the fiduciary concept beyond recognition.

The focus of the legislative history of the Advisers Act on preservation of the fiduciary relationship also supports limiting the class of plaintiffs in section 206 actions. Although the history contains references to the protection of "investors" and the "public," it is apparent from the context of those references, and from an examination of the kinds of adviser activities prevalent before 1940 that Congress sought to eliminate, that Congress intended to protect only those investors and members of the public who had consulted investment advisers.

Also instructive is that, in enacting the Advisers Act, Congress desired to avoid overregulating the advisory industry. In its view, the increasing technicalities of the marketplace created a need for advisers possessing a level of knowledge and expertise well beyond that of the ordinary investor. Excessive regulation, it feared, would discourage qualified individuals from entering the field—a consequence more undesirable than leaving certain activities unregulated. Limiting the plaintiff class to clients and prospective clients is a reasonable means of accommodating this congressional desire.

Implicit support for this limitation on the plaintiff class underlies the Third Circuit's decision in Kauffman v. Dreyfus Fund, Inc. There, plaintiff shareholders of certain mutual funds brought suit against, inter alia, allegedly malfeasant investment advisers to a large group of mutual funds, under various securities acts including the Investment Advisers Act. The court held that plaintiffs could bring suit only against advisers of the funds in which the plaintiffs held stock and were limited to bringing derivative actions on behalf of those funds rather than direct actions. In the investment company setting, the adviser's client is the company rather than its shareholders. In limiting the action in the investment company context to bona fide shareholders bringing derivative actions, the court assured that only the adviser's client would recover.

Finally, support for limiting the plaintiff class is provided by the two policy considerations set forth by the Supreme Court last term in

144. See S. Rep. No. 1775, supra note 64, at 21, quoted in the text at note 73 supra.
146. See note 6 supra.
147. See note 69 supra and text at notes 69-70 supra.
Blue Chip Stamps v. Manor Drug Stores,\textsuperscript{149} in which the Court upheld the viability of the purchaser/seller requirement\textsuperscript{150} in private suits under rule 10b-5. The Court noted that the elimination of the purchaser/seller requirement "would throw open to the trier of fact many rather hazy issues of historical fact the proof of which depended almost entirely on oral testimony."\textsuperscript{151} The determination whether a plaintiff would have purchased or sold securities but for the rule 10b-5 violation would be based in many instances on merely the uncorroborated oral evidence of the plaintiff:

The jury would not even have the benefit of weighing the plaintiff's version against the defendant's version, since the elements to which the plaintiff would testify would be in many cases totally unknown and unknowable to the defendant. The very real risk in permitting those in respondent's position to sue under Rule 10b-5 is that the door will be open to recovery of substantial damages on the part of one who offers only his own testimony to prove that he ever consulted a prospectus of the issuer, that he paid any attention to it, or that the representations contained in it damaged him. . . . In the absence of the [purchaser/seller requirement], bystanders to the securities marketing process could await developments on the sidelines without risk, claiming that inaccuracies in disclosure caused nonselling in a falling market and that unduly pessimistic predictions by the issuer followed by a rising market caused them to allow retrospectively golden opportunities to pass.\textsuperscript{152}

The purchaser/seller requirement viewed in this light thus serves as a rule of corroboration. The Court also emphasized that the effective elimination of the purchaser/seller requirement would create a grave potential for nuisance or "strike" suits and for misuse of the discovery procedure.\textsuperscript{153} Without such a requirement, virtually any plaintiff could make a colorable allegation of injury sufficient to withstand motions for dismissal or summary judgment since the inquiry in each case would involve delicate factual questions not subject to summary disposition. The resulting prospect of extensive discovery of business documents and the deposition of officers and associates, the disruptive effect of which would be costly to the defendant organization, would thus accord essentially groundless suits a substantial settlement value.

These considerations apply with equal force in the context of section 206 and encourage courts to employ a fairly rigid client/potential-client requirement. The trier of fact, in determining whether a nonclient plaintiff relied upon and was injured by an adviser's
fraudulent activities, would in most cases be forced to rely totally upon uncorroborated oral testimony, as in the 10b-5 context. Moreover, the absence of a client/potential-client requirement would present an unreasonable prospect of vexatious "strike" suits and of misuse of the discovery process.

If courts limit the class of section 206 plaintiffs to clients and prospective clients of investment advisers, they must determine what persons those categories encompass. Few problems arise in determining who is a client: once an advisory contract is entered into, or an advisory fee is paid, the relationship is clear. Problems do arise, however, in defining "prospective clients." The SEC has never adequately defined the term, although it has employed the "prospective clients" language of sections 206(1) and (2) for the purpose of taking administrative action against an adviser. The SEC concluded in Ralph Howard Seipel, the only action in which the term has had much significance, that "prospective clients" included persons actually solicited by the adviser for the purpose of making them clients. While that case involved direct telephone communications with persons answering the adviser's newspaper advertisements, the SEC's reasoning might equally have been applied to persons who had merely read the advertisements.

If effective restrictions are not placed on the definition of "prospective clients," any attempt to narrow the scope of the plaintiff class will be frustrated. Without restrictions, persons could maintain that they were "prospective clients" by merely reciting that they had intended to become clients of the adviser at some future date. It would be more in accordance with the legislative history of the Adviser's Act, and with the Supreme Court's rationale in Blue Chip Stamps, for courts to use the "prospective client" language to refer only to the time at which the section 206 violation occurred, not to plaintiff's status when the suit is brought. Under this interpretation, only clients could bring section 206 actions but they could recover for injury suffered as a result of adviser malfeasance that occurred while they were prospective clients. For example, if an adviser makes

---

154. The advisory contract need not be denominated as such. In Bolger v. Laventhal, Krekstein, Horwath & Horwath, 381 F. Supp. 260 (S.D.N.Y. 1974), the "investment advisers" were the general partners of a limited partnership, and the "clients" of those advisers were the limited partners. In this situation, the partnership agreement would function as an "advisory contract" for the purposes of determining who the adviser's clients are.

155. If there is no fee paid for advisory services, there is good reason to conclude that the profferor of those services is not an "investment adviser" within the meaning of section 206 and hence should not be amenable to suit under that section. For a discussion of the class of possible defendants in section 206 private actions, see text at notes 166-85 infra.

156. 38 S.E.C. 256 (1958). In revoking the adviser's registration in this case for fraudulent and deceptive solicitation of clients, the Commission stated that it was "immaterial" that the adviser had no clients at the time the misconduct took place.
material misstatements to a nonclient about the value of certain securities and if that nonclient subsequently becomes a client and suffers losses as a result of investing in (or failing to invest in) those securities, the client should be able to recover notwithstanding that the violations of section 206 occurred prior to establishment of the adviser/client relationship. In cases involving section 206 violations that occurred when the plaintiff was a "prospective client," courts should strictly enforce materiality and causation requirements: If these requirements are not adhered to, then an adviser who, for example, violates the advertising rule\textsuperscript{157} by including a former client's testimonial will be subject to damage liability to all persons who read the advertisement, became clients, and subsequently suffered losses due to the adviser's advice. Such expanded liability would certainly have a deleterious effect on the advisory industry, a result inconsistent with legislative intent.

Regardless of the scope of the plaintiff class in section 206 actions, it is necessary to determine the propriety of imposing additional requirements for bringing the action, akin to the "purchaser/seller" requirement for suits under rule 10b-5. Although there is no language in section 206 explicitly imposing such a limitation, a court could read these restrictions into section 206 by relying upon the reference to "investors" found in the legislative history of the Advisers Act.\textsuperscript{158}

The "purchase or sale" of securities requirement in 10b-5 actions, first articulated by the Second Circuit in \textit{Birnbaum v. Newport Steel Corp}.\textsuperscript{159} and recently affirmed by the Supreme Court in \textit{Blue Chip Stamps}, has been viewed as effectuating a congressional intent to preclude federal courts from "inquir[ing] into every decision affecting the management of corporations and then fashion[ing] a new federal law superseding state law on the fiduciary responsibilities of corporate directors, officers, and controlling persons."\textsuperscript{160} According to Professor Bromberg, "The requirement also serves a causation purpose, to assure that plaintiff has a real, rather than hypothetical injury."\textsuperscript{161} Recovery in the section 206 context could be limited to losses from buying or selling securities as a result of adviser malfeasance, thereby facilitating damage computation, reducing the prospect that courts would have before them only plaintiff's uncorroborated oral evidence, minimizing plaintiff recovery for conjectural injuries, and reducing the possibility of "strike" suits.

A requirement of this type would disallow recovery by a client

\textsuperscript{157} See text at notes 108-09 supra.
\textsuperscript{158} See, \textit{e.g.}, S. REP. No. 1775, \textit{supra} note 64, at 21.
\textsuperscript{159} 193 F.2d 641, \textit{cert. denied}, 343 U.S. 956 (1952).
\textsuperscript{160} Herpich v. Wallace, 430 F.2d 792, 809 (5th Cir. 1970).
\textsuperscript{161} 1 A. Bromberg, \textit{Securities Law} § 4.7(567) at 88.9-10.
who had purchased securities prior to consulting the adviser and had retained those securities to his detriment on the basis of the adviser's deceptive or fraudulent representations. Recovery would similarly be denied to a client who decided not to buy a certain security on the basis of adviser malfeasance. The injury of the client in such instances, however, flows from a breach of the adviser/client fiduciary relationship and logically should be redressed to protect that relationship adequately. It would seem appropriate, then, in light of the purpose of the Act, to allow recovery if competing interests can reasonably be accommodated.

One method of according these interests sufficient weight while allowing recovery where it is needed most is to impose the proposed client/potential-client limitation and a proof of causation requirement (discussed below162). If these two restrictions on recovery are applied, damage calculations will in most instances not be difficult: Courts can allow damages that will put the client in the position he would have been in had he not followed the adviser's recommendation. Moreover, courts will not be forced to decide delicate factual questions on the basis of plaintiff's uncorroborated oral evidence since advisers will have knowledge of the advice rendered, of the date it was rendered, of the strength of the advice, and, in many circumstances, of plaintiff's disposition to follow such advice. To be sure, difficult problems arise in determining whether the adviser's statements actually injured the client. But courts will have considerably more information on which to base the decision than in the rule 10b-5 context considered in Blue Chip Stamps. This information available to determine the legitimacy of plaintiff's allegations of injury will also reduce the possibility of plaintiff recovery for conjectural injuries and the feasibility of "strike suits." Neither, of course, will be entirely eliminated, but the possibility of both exists in many types of litigation and should not in this context be considered overriding. Imposition of client/potential-client and causation requirements should sufficiently reduce the possibility of either to allow courts to imply a section 206 cause of action without imposing a "purchase or sale" type of requirement.

Finally, support for the implication of a section 206 cause of action without the imposition of a purchaser/seller requirement can be found in Bolger v. Laventhol, Krekstein, Horwath & Horwath.163 There the court granted a motion to dismiss the rule 10b-5 claim because the "sale" did not occur "in connection with" the fraudulent conduct,164 but it did not dismiss the companion section 206 claim. The court discussed the purchaser/seller requirement only in the

---

162. See text at notes 186-92 infra.
164. 381 F. Supp. at 267.
context of the 10b-5 claim;\textsuperscript{165} it apparently did not think the require­
ment was applicable to section 206.

C. The Defendant Class

Section 206 of the Advisers Act regulates the activities of “investment advisers” rather than, like rule 10b-5, the activities of any
person. The section applies to all “investment advisers” as defined in
section 202(a)(11),\textsuperscript{166} including those who are exempt from registration with the SEC under section 203(b).\textsuperscript{167}

Section 202(a)(11) provides:

“Investment Adviser” means any person who, for compensation, en­
gages in the business of advising others, either directly or through
publications or writings, as to the value of securities . . . or who, for
compensation and as part of a regular business, issues or promulgates
analyses or reports concerning securities; but does not include (A)
a bank, or any bank holding company . . . which is not an invest­
ment company; (B) any lawyer, accountant, engineer, or teacher
whose performance of such services is solely incidental to the practice
of his profession; (C) any broker or dealer whose performance of
such services is solely incidental to the conduct of his business as a
broker or dealer and who receives no special compensation therefor;
(D) the publisher of any bona fide newspaper, news magazine or
business or financial publication of general and regular circulation;
(E) any person whose advice, analyses, or reports relate to no securi­
ties other than securities which are direct obligations of or obligations
guaranteed as to principal or interest by the United States . . . ; or
(F) such other persons not within the intent of this paragraph, as
the Commission may designate by rules and regulations or order.\textsuperscript{168}

While detailed, this definition is subject to conflicting interpretations.
It is therefore appropriate to consider whether the principal purpose
of section 206 justifies a broad construction. The exceptions listed in
section 202(a)(11) basically exclude persons who give investment
advice incidentally in the course of rendering other professional ser­
vices. Section 202(a)(11) literally seems to encompass, therefore, all
persons or entities on whom it is justifiable to impose fiduciary
obligations with respect to the dispensing of investment advice.\textsuperscript{169} A

\begin{itemize}
  \item 165. 381 F. Supp. at 265-67.
  \item 167. 15 U.S.C. § 80b-3(b) (1970). This section exempts from registration ad­
visers who do only “local” business and who do not deal in securities listed on na­
tional exchanges, advisers whose only clients are insurance companies, and advisers
who have had fewer than 15 clients over the course of the past year and who neither
hold themselves out as advisers to the general public, nor act as advisers to invest­
ment companies.
  \item 168. The author’s research unearthed no decisions in which an alleged violator
has challenged the SEC’s enforcement of section 206 by claiming that he is not an
“investment adviser.”
  \item 169. “Section 202(a)(11) of the [Investment Advisers] Act lists a number of
\end{itemize}
broader construction could expose to liability advisers not fairly engaged in a fiduciary relationship with the plaintiff, and/or those not engaged in rendering investment advice who aid or abet or otherwise participate with a bona fide adviser in a violation of section 206.

Section 202(a)(11) gives the SEC the power to determine who falls within the “intent” of that provision, a power used in numerous advisory letters over the years attempting to explicate which persons or entities fall within the definition of “investment adviser.” The SEC decisions suggest that, in general, if the services being offered “can be used to determine the value of securities and the advisability of investing in, purchasing or selling securities,” and are being offered for a fee to the general public, then the person rendering those services is an “investment adviser” within the intent of the Advisers Act regardless whether the services contain a value judgment with regard to the analyzed securities. On the other hand, where the advice is given exclusively to members of the adviser’s family or to close personal friends, even if a fee is charged, the adviser is not an “investment adviser” within the intent of section 202.

Thus, in delineating the class of “investment advisers,” the SEC has focused on the business aspects of the adviser’s services and attempted to separate those advisers who, by representing themselves examples of persons or entities whose activities might fall within the broad definition of ‘investment adviser’ but whose customary practices would not place them in the special, otherwise unregulated, fiduciary role for which the law established standards.” SEC v. Wall St. Transcript Corp., 422 F.2d 1371, 1377 (2d Cir.), cert. denied, 398 U.S. 958 (1970). See generally 2 L. Loss, supra note 14, at 1396-401; Loomis, supra note 7, at 246 (“Since there are a multitude of persons who have and express ideas or factual data about the stock market and many hope to derive some return from such expressions, the scope of the basic definition turns largely upon the phrases ‘engaging in the business’ or ‘as part of a regular business.’” (footnotes omitted)).


to the public as experts, have incurred fiduciary obligations to their clients, from those advisers who, by functioning in a purely personal setting, have not. In so doing, the SEC seems accurately to have assessed and implemented congressional intent. In so far as the purpose of section 206 is simply to preserve the fiduciary relationship where it exists, there is little reason for courts to dispute the SEC's presumptively valid interpretation of "investment adviser" and broaden or restrict the definition to any significant degree.174

The propriety of exposing to section 206 liability those who aid or abet otherwise figure in a violation of that section arose in both decisions discussing the implication of a section 206 cause of action. Accountant-defendants in Bolger v. Laventhol, Krekstein, Horwath & Horwath allegedly "aided and abetted" a section 206 violation by accepting money from the "investment advisers" (general partners) of a limited partnership in return for falsifying the partnership's financial statements. The court rejected the accountants' contentions that section 206 should be read literally:

[T]he fraudulent activities of the accountant-defendants in this suit were inexorably intertwined with the fraud being perpetrated against the limited partners by [the partnership's] investment advisors. To deny to these investors, who were injured by this combined fraudulent conduct, a cause of action against all of the wrongdoers would leave the plaintiffs with half a remedy and would run afoul of the Supreme Court's repeated admonition that the securities laws are to be construed "not technically and restrictively, but flexibly to effectuate [their] broad remedial purposes".175

174. In the one case in which the issue whether the defendant was an investment adviser was raised, the court rejected the SEC's interpretation. In Selzer v. Bank of Bermuda Ltd., 385 F. Supp. 415 (S.D.N.Y. 1974), the plaintiff, the beneficiary of a trust established to invest in American securities, brought suit against the defendant bank trustee under, inter alia, sections 206, 214, and 215 of the Advisers Act. 385 F. Supp. at 417. The court noted that the SEC had recently ruled that a trustee of an investment trust was an adviser within the meaning of the Act, 385 F. Supp. at 420, but went on to state:

A trustee is historically the legal owner of the trust corpus, while the beneficiary is the equitable owner. The trustee does not advise the trust corpus, which then takes action pursuant to his advice; rather the trustee acts himself as principal. While there may be public policy reasons for holding a trustee who deals in securities for its trust to the standards of the Investment Advisers Act, neither the common sense meaning of the word "adviser" nor a comparison with other situations to which the 1940 Act has been held applicable militates in favor of doing so. The Court therefore finds that the Investment Advisers Act is not available in a suit against a trustee in these circumstances. 385 F. Supp. at 420.

What the court in Selzer failed to recognize is that the term "investment adviser" should be interpreted not only in the light of common sense, but also in accordance with legislative intent. To the extent that a bank solicits business as a trustee by holding itself out to the public as competent to make investment decisions it would seem squarely to fall within the intent of the definition of investment adviser in the Act.

The court in *Greenspan v. Campos del Toro*, however, reached the opposite conclusion on the ground that, since section 206 "applies only to 'investment advisers,' only such persons should be amenable to suit."  

The *Bolger* court apparently relied at least in part on the amenable to liability of aiders and abettors and co-conspirators under rule 10b-5. Section 206 and rule 10b-5 are distinguishable, however. While "[t]he phrasing of 10b-5, particularly 'any person,' 'scheme . . . to defraud' and 'course of business which operates . . . as a fraud,' invites inspection of broad spectra of conduct and of all the actors in them," section 206 appears to limit the inspection of actors in fraudulent schemes to those within the definition of investment adviser.

Despite the language differences between these provisions, there are valid reasons why courts should expose secondary culpable actors to section 206 liability. First, a refusal to allow suit under section 206 against aiders and abettors or co-conspirators of investment advisers would often create incongruous results. For example, suppose an investment adviser and a broker-dealer enter into an arrangement whereby the adviser agrees to direct all of his clients' portfolios to the dealer in return for credit against equipment expenses—a "prima facie" violation of section 206 according to the SEC. Under this arrangement, the adviser would profit to the extent of the credit received and the broker-dealer would profit to the extent of the brokerage fees generated by the accounts referred. If the adviser's clients are injured by this arrangement, by receiving inadequate or biased execution of their accounts, it seems inappropriate to insulate from liability the broker-dealer who has profited by the violation often more than the adviser. Second, in many situations the culpable nonadviser may be the only economically viable source from which the plaintiff can recover. Third, the nonadviser in many situations will be a professional—e.g., accountant, lawyer, or broker-dealer—

---

177. Order of Dismissal at 3.
179. 2 A. Bromberg, supra note 161, § 8.5(515), at 208.4.
181. The broker-dealer may profit in other, more subtle, ways by this arrangement. The adviser's clients may recommend the broker-dealer to other persons, or may continue using the broker-dealer's services once their relationship with the adviser has been terminated.
182. This was apparently true in *Bolger* where plaintiffs, limited partners of a since-dissolved limited partnership, sought to recover from the accountants that had prepared the partnership's financial statements, rather than from the investment advisers (general partners) themselves.
who, in his own right, owes a duty of “fair dealing” to the public. 183
Finally, it would be unreasonable to deny recovery under section 206
from aiders and abettors or co-conspirators when such recovery is
available under rule 10b-5 in situations where there is an actual
purchase or sale of securities in connection with adviser misrepræsen-
tation or nondisclosure. Denying recovery from nonadvisers under
section 206 while permitting it under rule 10b-5 would mean, for
example, that plaintiffs could recover under rule 10b-5 from nonad-
visers in a case like Bolger if the partnership is dissolved “in connec-
tion with” the adviser’s fraudulent activities, 184 but could not recover
under section 206 if the partnership is dissolved (as it was in Bolger)
after the commission of the fraudulent activities. Certainly, the
culpability of the nonadvisers is no greater in the former case than in
the latter.

If courts do include secondary culpable parties in the class of
persons amenable to suit under section 206, they should insist on a
showing that these secondary parties had knowledge of the illegal
actions of the investment adviser. Without such a showing, fiduciary
obligations of these parties would equal or exceed the obligations
imposed on advisers themselves under section 206. As has been said
with regard to the liability of aiders and abettors and co-conspirators
under the 1933 and 1934 Acts: “Deviation from [the knowledge]
requirement would unreasonably impose liability on secondary de-
fendants. Adherence to [this] requirement still allows imposition of
liability in appropriate cases, since knowledge can be shown by
reckless conduct or through inference.” 185

D. Causation and Reliance

The interplay of several concepts underlies the issue whether an
adviser’s malfeasance caused the client’s alleged injury. When the
malfeasance involves misrepresentation or nondisclosure, causation is
best thought of in terms of client reliance and the materiality of the
information misrepresented or not disclosed. When the malfeasance
is of some other sort, causation becomes more complex and more
weighty policy factors militate against the imposition of any absolute
causation requirement.

In establishing a causation requirement for adviser misrepresenta-
tion or nondisclosure, effective analogy can be made to the rule 10b-5

183. For a discussion of how tort-law theories of liability for breach of a
professional defendant’s obligations to the public might affect his secondary liability
under rule 10b-5, see Ruder, supra note 178, at 612-18.

184. This might have occurred if, for example, the general partners/advisers had
attempted to make the financial situation of the partnership look worse than it really
was in an effort to have the partnership dissolved in order to take over its accounts
later on.

185. Ruder, supra note 178, at 638.
context. There courts have eschewed requiring plaintiffs to show affirmatively that they relied on the informational error.\textsuperscript{186} The difficulty in proving or disproving reliance, as Professor Bromberg has noted, "is likely to produce only a ritual of pleading followed by 'I relied' testimony from the plaintiff."\textsuperscript{187} Instead, courts have focused on the issue of materiality—whether information that a reasonable investor might have considered important in making investment-related decisions has been misrepresented or withheld.\textsuperscript{188} Because of the "potential massive liability to hordes of investors who are in fact trading on a variety of data, appraisals, and intuitions,"\textsuperscript{189} a strict materiality requirement has been necessary to limit liability.\textsuperscript{190}

With slight alteration, this approach seems appropriate to apply to section 206 actions alleging nondisclosure or misrepresentation. By limiting the plaintiff class to clients and the defendant class to bona fide advisers, section 206 actions would be restricted to situations where reliance by the plaintiff is both reasonable and expected. Indeed, it is fair to assume that when a client acts in accordance with an adviser's opinion, he does so in reliance upon that opinion. Courts thus could presume reliance in all instances of material misrepresentation and nondisclosure.\textsuperscript{191} In light of the congressional desire to

\begin{itemize}
  \item \textsuperscript{186} See, e.g., Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972).
  \item \textsuperscript{187} 2 A. BROMBERG, supra note 161, § 8.6(2), at 210.
  \item \textsuperscript{188} See, e.g., Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972).
  \item \textsuperscript{189} 2 A. BROMBERG, supra note 161, § 8.3, at 199.
  \item \textsuperscript{190} Id.
  \item \textsuperscript{191} In Competitive Capital Corp. v. Yamada, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,617 (S.D.N.Y. June 26, 1974), a private damage action brought by a mutual fund and the fund's manager against, \textit{inter alia}, the same accountant-defendants as in the Bolger case and alleging violations of section 17a of the 1933 act, section 10(b) of the 1934 act, and section 206 of the Advisers Act for the same conduct alleged to be violative of section 206 in Bolger (i.e. the certification of false financial statements of Takara, Ltd.), the court granted the accountant-defendants' motion to dismiss because the plaintiffs failed to show that they had relied on the statements prepared by defendants.
  Plaintiffs in \textit{Competitive Capital} alleged that they had been induced to hire defendant Yamada, general partner and "investment adviser" of Takara, Ltd., as a fund manager on the basis of information provided by Yamada to plaintiffs describing the "success" of the Takara operation. The accountant-defendants, by preparing Takara's false financial statements, were alleged to have been involved in the fraud that induced plaintiffs' decision. The court found that plaintiffs could not have relied on the accountant-defendants' activities, as there was evidence that plaintiffs did not see Takara's financial statements until four days before they fired Yamada. The problem with the court's reasoning in \textit{Competitive Capital} is that it makes the accountant-defendants' liability turn solely on whether plaintiffs relied on a financial statement prepared for a totally different purpose. The court should have focused on whether the accountant-defendants knew of Yamada's fraudulent scheme to convince the Fund to hire him. If knowledge of, and participation in, the scheme to defraud the Fund was present, then plaintiffs, who could justifiably be presumed to have relied on their relationship with their investment adviser, should have been able to recover whether or not they had relied on the statements certified by the accountants.
\end{itemize}
avoid overregulation of the advisory industry, however, it seems reasonable to afford defendants an opportunity to prove that reliance did not in fact occur or should not reasonably have occurred. The requirement of materiality could be applied in a manner similar to the rule 10b-5 context, tempered, perhaps, by taking into account subjective factors such as the particular plaintiff's sophistication in the securities market. This tempering seems appropriate, first, because the amount of disclosure that satisfies an adviser's fiduciary duties should to some degree turn on the client's sophistication, and, second, because minor misrepresentations might mislead an unsophisticated client when a more knowledgeable one should not reasonably be misled.

The causation requirement in the context of section 206 violations not involving nondisclosure or misrepresentations should be applied both to compensate clients for injuries actually suffered and to preclude defendants from being enriched by their violations. In many instances of unlawful adviser/client or adviser/broker-dealer arrangements, clients will be unable to prove that any specific loss or any missed opportunity for gain resulted from the section 206 violations. In such instances, courts should allow plaintiffs to recover restitutionary damages in the amount of the defendants' enrichment. Where advisers receive unlawful payments or credits from broker-dealers, for example, clients should have the opportunity to recover the value of those payments or credits in lieu of recovering actual damages. One problem raised by this approach is that of allocating these payments or credits among the adviser's clients. In other areas, however, such as the area of copyright or patent infringement, courts have not hesitated to make a rough allocation in determining the amount of profits attributable to the infringement and have resolved all reasonable doubts in favor of the plaintiff. A similar approach toward allocation seems appropriate in this context.

When plaintiff can demonstrate a reasonable causal connection between the section 206 violation and actual losses, recovery should, of course, be allowed. Recovery of actual damages in absence of causation, however, seems inappropriate. In Courtland v.

192. If courts do indeed limit the class of plaintiffs who can sue under section 206 to clients and limit defendants to "investment advisers," there would be no reason not to take these subjective factors into account in determining the materiality of defendant's misrepresentation or nondisclosure. This would be more equitable than, for example, using the SEC's "unsophisticated investor" test to determine liability in all instances.


194. In Abrahamson v. Fleschner, 392 F. Supp. 740 (S.D.N.Y. 1975), the court, analogizing to the rule 10b-5 context, dismissed the plaintiffs' section 206 claim because plaintiffs suffered no out-of-pocket losses as a result of defendants' fraudulent acts. The issue whether "actual losses" should be restricted to out-of-pocket losses in section 206 actions is beyond the scope of this Note.
Walston & Co., the district court apparently abandoned the causation requirement and relied instead on the Second Circuit’s opinion in Pearlstein v. Scudder & German to permit a plaintiff who was in pari delicto to recoup her losses from a defendant who had engaged in a fraudulent scheme violative of both rule 10b-5 and section 206. What the Courtland court overlooked, however, was the fact that, although plaintiff in Pearlstein had been in pari delicto, his losses clearly had resulted from the allegedly fraudulent conduct. Allowance of recovery without a causal connection seems unnecessary in light of the availability of both restitutionary recovery and SEC sanctions. Moreover, in the absence of a causation requirement, advisers could be subjected to liability grossly disproportionate to the wrong; qualified individuals might thus be deterred from entering the advisory field—a result Congress wanted to avoid.

E. Scienter

Establishing a scienter requirement doubtless will be one of the most difficult tasks for courts constructing a section 206 cause of action. As Professor Bromberg has stated: “One of the most troublesome aspects of fraud litigation is the requisite state of mind of the parties. The complexities relate primarily to the defendant and focus initially on what scienter or state of mind (in terms of intent, purpose, knowledge or belief) is necessary to frame a cause of action against him.” When conduct not involving misrepresentation or nondisclosure is at issue, courts may find the imposition of strict liability often appropriate. Most such violations turn on unlawful adviser/broker-dealer or adviser/client arrangements, or unlawful fee arrangements. Unless advisers are allowed the unusual defense of ignorance of the law, it should suffice to show that the adviser knew of the arrangement.

197. The alleged violation involved a scheme whereby the adviser would “tip” his individual clients as to stock later recommended to subscribers in a newsletter published by the adviser. The court emphatically upheld plaintiff’s right to recover under both section 206 and section 10(b) of the Exchange Act:
I find that defendants were making recommendations to customers of stocks prior to the appearance thereof in the weekly market letter, and were offering to give plaintiff, and presumably others, the benefit of advance notice of what would appear in the market letter. This, without more, is a fraudulent and deceptive device in connection with the sale of securities. It had as its purpose, effective in the case of plaintiff, to induce the sale of securities which she owned, through defendants, and the purchase of securities recommended by defendants. This, of course, generated a trading volume, and produced brokers, commissions beneficial both to the registered representatives advising plaintiff and to plaintiff’s broker. Use of this device, without more, gives rise to liability, although it is satisfactorily established that the securities recommended were considered “good” recommendations, and that the sales recommendations made are justified . . . .
198. 2 A. Bromberg, supra note 161, § 8.4(000), at 203.
More difficulties arise in establishing scienter for misrepresentation and nondisclosure since advisers cannot be required to know everything about the corporations whose securities they recommend. The scienter requirement for actions under rule 10b-5, to which analogy again is appropriate, remains unclear.199 Although courts have generally agreed that plaintiff need prove something less than common-law fraud to state a claim under rule 10b-5,200 there has been little agreement as to what that "something less" must be. The Second and Ninth Circuits, in particular, have traditionally taken opposite positions on whether proof of defendant's negligence alone is enough to sustain a rule 10b-5 claim;201 the Ninth Circuit has generally found negligence sufficient202 while the Second Circuit has not.203 In recent years, however, both circuits have moved away from the approach of framing the issue in terms of "scienter" and have begun to focus instead on whether the defendant owed a duty of disclosure to plaintiff in the circumstances of the case and whether that duty was breached.204 The Second Circuit has formulated a fairly strict standard of "duty" under rule 10b-5: "The standard for determining liability under Rule 10b-5 essentially is whether plaintiff has established that defendant either knew the material facts that were misstated or omitted and should have realized their significance, or failed or refused to ascertain and disclose such facts when they were readily available to him and he had reasonable grounds to believe that they existed."205 The Ninth Circuit, on the other hand, has chosen to remain more flexible in light of the "varied factual contexts" in which rule 10b-5 claims arise206 and has articulated various considerations for determining a particular defendant's duty of disclosure under that rule: Without limiting the trial court from making additions or adaptations in a particular case, we feel the court should, in instructing on a defendant's duty under rule 10b-5, require the jury to consider the relationship of the defendant to the plaintiff, the defendant's access to

199. See generally id. §§ 8.4(500)-(690).
200. Id. § 8.4(501), at 204.101.
202. See, e.g., Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961).
206. See White v. Abrams, 495 F.2d 724, 732-35 (9th Cir. 1974).
the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.\textsuperscript{207}

Section 206 private actions involving misrepresentation and nondisclosure provide an appropriate context in which to apply this "duty/breach" approach to scienter problems. As phrased by the Supreme Court in \textit{Capital Gains}, an adviser has toward his client "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts.'"\textsuperscript{208} In light of the fiduciary nature of this relationship, courts facing allegations of nondisclosure should require more of advisers than that they ascertain and disclose material facts that are "readily available," as the Second Circuit has done in the rule 10b-5 context. Because advisers are paid to unearth facts material to the investment decision, a standard of reasonable diligence seems more appropriate.

In dealing with allegations of misrepresentation or nondisclosure,\textsuperscript{209} courts must decide whether to allow recovery for mere negligence or whether a "reckless disregard" standard would be more justified. The kind of self-policing that would be promoted by allowing recovery for negligent conduct is certainly a desirable goal. On the other hand, while the Supreme Court in \textit{Capital Gains} found "that Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit' upon a client, did not intend to require proof of intent to injure [under section 206],"\textsuperscript{210} it is suggested by the history surrounding the passage of the Advisers Act that the kinds of conduct Congress sought to eliminate involved "knowing" participation by investment advisers.\textsuperscript{211} The exact standard courts employ is less important than a judicial appreciation of the fact that advisers are constantly called upon to render opinions on a wide variety of investments. Clients investing large amounts of money and paying for researched, reasoned determinations should reasonably expect a more thorough opinion than should a client investing small sums who asks his adviser for an immediate opinion on the worth of a particular security. Using prevailing industry practices as a guide and factoring in the materiality of the misinformation, courts should fashion a test that encourages responsible practices without requiring

208. 375 U.S. at 194.
209. Standards of "negligence" or "reckless disregard" will rarely be illuminating in the context of noninformational violations of section 206. To label as "negligent" the adviser who enters into an agreement that is a prima facie violation of section 206 is to understake the culpability of the adviser vis-à-vis the client.
210. 375 U.S. at 195.
211. See note 6 supra and accompanying text; note 62 supra.
advisers to research each recommendation so thoroughly that they must charge fees beyond the means of the average individual investor.

III. CONCLUSION

The similarities between section 206 and rule 10b-5 and the need for private enforcement of section 206 to supplement SEC efforts strongly recommend the judicial implication of a cause of action under that provision. While a section 206 action would overlap substantially with the private action under rule 10b-5, an implied private cause of action could be of significant aid, first, because of the lack of "in connection with" and "purchase or sale" requirements, second, because recovery for fraudulent activities not involving misrepresentation and nondisclosure would be allowed, and, finally, because restitutionary recovery would be possible without a demonstration of causation.