

# Michigan Law Review

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Volume 65 | Issue 8

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1967

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### Recommended Citation

Robert N. Leavell, *Investment Advice and the Fraud Rules*, 65 MICH. L. REV. 1569 (1967).  
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# INVESTMENT ADVICE AND THE FRAUD RULES

Robert N. Leavell\*

## I. INTRODUCTION

EVERY day thousands of Americans are assaulted by mail, telephone, and personal contact with advice on how to invest their money for capital gains, often with dazzling reminders of the opportunity for great profits.<sup>1</sup> If the advice is good, they may indeed one day have their treasure ship which will send their children to college or provide a round-the-world trip after retirement. If the advice is bad, they will of course learn by experience. But many of them will have to apply their lesson to a second inheritance or twenty years' savings. The quality of investment advice is therefore a subject with serious human implications, and implications, too, for the health of a national economy which depends on investment by the masses.<sup>2</sup> This article aims to tell something about who gives the advice, how it is formulated, and what legal controls govern its sincerity and competence.

This analysis draws heavily upon the lode of information exposed by the Special Study of Securities Markets, conducted by a special staff under the general supervision of the Securities and Exchange Commission, as well as material which has come to light in considering the recommendations of that group.<sup>3</sup>

## II. TYPICAL FIRM ACTIVITIES, SOURCES OF CONTROL, AND RESEARCH TECHNIQUES

The deluge of oral and printed investment advice comes from firms engaging in a wide range of activities. What these activities are and who regulates them are of interest at this point, leaving for later a more detailed examination of the legal controls. Also included by way of background are some comments about the research

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1. For some interesting examples, see Securities & Exchange Commission, *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, 367-68 (1963). [Part 1 of the Commission's report is hereinafter cited as *Special Study*.]

2. *Id.* at 9-11.

3. See *Special Study*.

techniques which are used by those in the securities business in examining stocks to determine their investment merit.

### A. *Activities and Who Control Them*

Most investment advice comes from either broker-dealer firms or "publishing firms"; both perform a variety of services, although the activities of the numerically larger broker-dealer group are likely to be the most varied.<sup>4</sup> A broker-dealer firm is out to bring about purchases and sales in order to earn commissions; it may also be seeking a profit on stocks it already owns, or, as it is usually put, in which it has an "inventory." To attract business it distributes at least one weekly "market letter" with advisory suggestions to a large number of customers and potential customers. The firm hopes that the recipient will be prompted by what he reads to make or consider a purchase or sale. When the distributed materials have the desired effect, the potential customer usually contacts a firm salesman (or "customer's man") with whom the transaction is at least briefly discussed. This salesman is on the telephone during the day suggesting investment action to customers and potential customers, basing his comments on the market letters or on other information drawn from his firm's research department as well as from his own "research." To aid him, there is usually a wire service which he uses to send inquiries about specific stocks to personnel at the home office and from which he receives a steady flow of advisory data and suggestions.

The firm does not charge the customer separately for these services, but regards them as paid for by the commissions earned from the buying and selling it handles for the customer. The firm may also supply, at no charge, detailed studies of industries and individual securities to a select group of customers, usually referred to as "institutional" investors, whose purchases and sales involve large sums. As a further service, it may offer to review customers' portfolios, doing this free of charge. Fees, however, may be charged for such advisory services as continuous portfolio management.

Variety is also to be found in the activities of "publishing firms" which sell advice to their subscribers.<sup>5</sup> They seek subscriptions by extensive newspaper advertising, direct mail solicitation, and by personal contact. To induce subscriptions they distribute special advisory materials and offer to review a new subscriber's portfolio

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4. The summary which follows is drawn from *id.* at 330-33, 344-58.

5. *Id.* at 353, 359-69.

without charge. Many also derive a large part of their income from managing portfolios for a fee.

Because broker-dealer firms are avid subscribers to advisory publications, and because their salesmen are avid users of them, the advice of publishing firms often influences the broker-dealer's recommendations.

Both kinds of firms, and those whom they employ, are regulated in several ways. In the case of the broker-dealer firm, the extent of the regulation will depend on whether it trades in both "listed" and "unlisted" stocks, as well as on whether it charges for any of the investment advice services it offers. If the firm buys and sells *listed* stocks for its customers on a regular basis, it must have a membership on the stock exchange which has accepted the stock for listing.<sup>6</sup> Exchange membership subjects the member firms, most of whom actively supply information and advice to obtain brokerage business,<sup>7</sup> to the rules and disciplinary procedures of the exchanges. The exchanges are commonly talked of as being self-regulatory; despite this epithet, they have not been entirely self-regulating since the adoption of the Securities Exchange Act of 1934, requiring that they be registered with the Securities Exchange Commission (SEC) which controls various aspects of their activities.<sup>8</sup>

Dealing in *unlisted* securities involves additional relationships. Most firms seeking to buy or sell on commission, or to sell from their own inventories, unlisted securities traded in the over-the-counter market find it necessary to be members of the National Association of Securities Dealers (NASD),<sup>9</sup> even though they may also be members of an exchange. The NASD came under extensive federal control when, in 1938, the Securities Exchange Act was amended to require that it register with the SEC.<sup>10</sup> Organized on a national basis, the NASD has regional committees to police the conduct of its members under NASD rules.<sup>11</sup> In addition, all broker-

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6. *Id.* at 11-14 (as this material indicates, "allied" membership arrangements have increased greatly in recent years). There is a relatively small but increasing percentage of over-the-counter trading in listed stocks. *Id.* at 14. See also 2 Loss, *SECURITIES REGULATION* 1172 n.8 (2d ed. 1961) [hereinafter cited as Loss].

7. *Special Study* 244-50, 344-45.

8. 2 Loss 1165-83.

9. In trading with nonmember broker-dealers, National Association of Securities Dealers members must charge the same price as they charge the general public, whereas member broker-dealers may be given a "wholesale" price. *Special Study* 13.

10. 2 Loss 1359-91; with respect to SEC control of over-the-counter brokers and dealers, see *id.* at 1288-358.

11. NATIONAL ASSOCIATION OF SECURITIES DEALERS, NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL C-25 to -33 (By-laws), D-23,-24 (Rules of Fair Practice, art. IV) (1965). See also 2 Loss 1371-80.

dealer firms conducting an interstate over-the-counter business must also register with the SEC,<sup>12</sup> which, as will be seen, exercises important controls over them.

The individual securities salesman is required to register with the NASD, if he is employed by a member firm, as well as to register with any exchange to which his firm belongs.<sup>13</sup>

For those firms which sell printed advisory literature, or, for a fee, offer advice on a personal basis, but do not act as a broker or dealer in the purchase and sale of stocks, there is at present no self-regulatory or cohesive national organization.<sup>14</sup> However, the Investment Advisers Act of 1940 requires that these firms be registered with the SEC as "investment advisers."<sup>15</sup> Exchange and NASD members engaging in advisory activities for which they charge a fee must also be registered with the SEC as "investment advisers."<sup>16</sup>

### B. Research Techniques

Investment recommendations pouring out from these sources have, of course, been arrived at in various ways, many of which are highlighted in the following summary of the Special Study findings. They are the product of a process—called here the "advisory process"—which ordinarily involves three steps. The first, or formulation, step involves the study of the particular stock and the formulation of conclusions with respect to its investment merits. There are essentially two broad approaches used in the evaluation of securities, the "fundamental" and the "technical."<sup>17</sup> Individual analysts by and large adhere to one approach or the other; those who use the fundamental approach are known as security analysts, and those who use the technical approach are known as market analysts.

Security analysis is the basis for the great bulk of investment advice. The security analyst studies—in varying degrees, depending upon the purpose and thoroughness of his examination—such basic matters as the company's financial statements, earnings, the ratio of

12. Securities Exchange Act of 1934 § 1-34, 48 Stat. 881, as amended, 15 U.S.C. §§ 78a to hh-1 (1964) [hereinafter cited as Exchange Act]. See also *Special Study* 69; 2 Loss 1288-94.

13. *Special Study* 116-17, 120-22, 129; 2 Loss 1367-69, 1386-87.

14. *Special Study* 148. See also *id.* at 386, para. "5." The *Special Study* recommended that this be considered.

15. Investment Advisers Act of 1940, § 203, 54 Stat. 850, 15 U.S.C. § 80b-3 (1964); *Special Study* 148.

16. Investment Advisers Act of 1940, § 203, 54 Stat. 850, 15 U.S.C. § 80b-3 (1964). See also *Special Study* 146.

17. The brief textual comment concerning these two techniques is taken from *id.* at 332. For a detailed treatment of the security analyst's task, see GRAHAM, DODD & COTTLE, *SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES* (4th ed. 1962).

the stock's price to the company's earnings and cash flow, dividends, management, sales, markets, competition, products, and product changes. Also of concern to him are the many economic and political forces which affect the company, the price of the security, and market prices in general.

Technical or market analysis is concerned almost exclusively with the interior action of the stock market itself: the patterns of securities prices and the volume of trading. The market analyst may study "point and figure" charts or data relating to such things as odd-lot transactions and insiders' transactions. He examines trends in the immediate past in the hope that they will give indications of movements in the immediate future. He is more concerned with timing than the security analyst, and, as a result, the investor who acts on his recommendation tends to be more oriented toward trading than investing.

Despite its obvious importance, this formulation stage of the advisory process has received very little regulatory attention. Most controls have centered on the second, or communication, stage which entails communicating in detailed or abbreviated form<sup>18</sup> the results of the formulation stage to the person, usually the investor, who will make an investment decision. The final step involves the process of reaching a decision as to what action, if any, the investor, or one acting for him, will take.<sup>19</sup>

### III. THE SPECIAL STUDY FINDINGS CONCERNING INVESTMENT ADVICE

The Special Study makes it possible as never before to tell the story of what goes on in the investment advice world.<sup>20</sup> The summary of its findings occupies some fifty pages of eight-point type.<sup>21</sup> It will only be possible to hit such of the high spots as provide a back-drop for the discussion of controls. The reader should be warned that the whole story is interesting reading, and also that it is far more detailed and complex than is apparent from what follows.

The Special Study findings were based upon a comprehensive examination of the advisory activities of all segments of the invest-

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18. See text accompanying note 28 *infra*.

19. All three steps may be undertaken by the adviser, as in the case of an adviser's doing his own research for accounts over which he has discretionary control.

20. The great earlier investigation, that of Pecora, did not give detailed consideration to investment advice problems. See PECORA, WALL STREET UNDER OATH (1939). See also 2 LOSS 1166.

21. *Special Study* at 330-87.

ment advisory community. All the advisory communications, over a significant period of time, of firms of all types and sizes were examined, in many instances by going to the firms and questioning all of those who had a hand in formulating the advice or in getting it to the customer.<sup>22</sup> Considered in these inquiries were oral communications, printed advisory materials of all types including regular market letters and subscription publications, special detailed reports sent to large institutional investors, portfolio analyses, and advertising materials. The Special Study also selected for particular attention securities which, aided by extensive favorable advisory comment, had undergone a phenomenal rise in price, only to become worthless shortly thereafter. In the case of these, the history of every recommendation from every source was investigated in detailed manner.

Perhaps the most striking impression gained from the Study findings is the remarkable disparity both between the conduct of different investment advisers and the ways in which those in the field view their responsibilities.<sup>23</sup> Responsible investment advice requires that analysts have special skills to analyze the operations and market prospects of the corporation in question, and it entails an awareness of what data is essential to such analysis, as well as, of course, the availability of that data in reliable form.<sup>24</sup> Because the analysis necessarily involves a determination of the merit of the corporation's securities in relation to that of other companies in the same industry—calling for considerable familiarity with the industry as a whole<sup>25</sup>—some firms are of the opinion that a skilled securities analyst could not responsibly originate recommendations about securities in more than two industries.<sup>26</sup> Firms whose research departments are organized around analysts whose responsibilities are limited in this way also require that all recommendations originate with, or have the approval of, the analyst responsible for the industry of which the issuer is a part.<sup>27</sup> Such opinion and conduct, however, are at one extreme of the spectrum. The vast bulk of advisory recommendations were found to originate under other circumstances. In some broker-dealer firms one or two men supply advice in response to a steady flow of requests from a large number of salesmen while at the same time supplying the content of one or more advisory

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22. The investigative approach used is summarized in *id.* at 333-34.

23. *Id.* at 144-45, 344, 348-49, 351-53, 356-58, 360-66, 369-74, 384-86. There was also a disparity between standards professed and the practices followed. *Id.* at 384.

24. *Id.* at 344. For a contrast in analytical approach, see *id.* at 351-53.

25. See text accompanying note 17 *supra*.

26. *Special Study* 353. See also *id.* at 351.

27. *Id.* at 353, 365; *cf. id.* at 144-45.

publications.<sup>28</sup> Their recommendations, necessarily, are based to a large extent upon printed advisory materials prepared by persons outside the firm and upon occasional statements obtained from corporate insiders.<sup>29</sup> In such firms, new and inexperienced employees are assigned the task of sending replies to the salesmen who call or wire for advice, while the limited staff of experienced and trained analysts prepares detailed advisory reports for special classes of potential customers, such as institutional investors.<sup>30</sup> Equally casual is the manner in which such firms prepare the "portfolio analyses" for customers who respond to invitations to submit their investments for review.<sup>31</sup> In many instances, as a matter of course, recommendations are formulated by salesmen from whatever materials and information are at hand, without consulting even the firm's own "research department."<sup>32</sup>

Although less conspicuous, there are, according to the Study, publishing firms with research personnel so few in number, in relation to the coverage and services offered, that only the most superficial examination is made of the stocks recommended.<sup>33</sup> While both subscription publications and broker-dealers often treat the technical position of the market as an important factor in the timing of a suggested change in investment position, the recommendations of some publishing firms are based almost *entirely* upon this technical approach to market analysis, although this often is not made apparent to the investor.<sup>34</sup> This method of analysis makes possible the issuance of countless recommendations despite extremely few personnel.<sup>35</sup>

Hitting bottom, finally, at the other extreme of this advisory conduct spectrum, the Study found that there are firms disseminating recommendations without any semblance of inquiry as to the effect of current conditions on the issuer of the security.<sup>36</sup> Usually this comes about because a firm has too few analysts to maintain the steady flow of recommendations necessary to service its publication or salesmen's demands. There are, however, conspicuous examples of such conduct during periods of great market

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28. *Id.* at 144-45, 350-52, 358, 384. See also the saga of Dunn Engineering, *id.* at 334-44.

29. *Id.* at 144, 351-55, 358, 384-85.

30. *Id.* at 145, 357-58, 374, 384.

31. *Id.* at 145, 245-46, 358, 384.

32. *Id.* at 142, 278, 285, 353.

33. *Id.* at 363-67, 384-85.

34. *Id.* at 332-33, 348-49, 361-62, 366.

35. See especially *id.* at 363-65 on the wonders of this "crystal ball for looking ahead."

36. *Id.* at 334-44, 363-65. See also note 24 *supra*.



activity in speculative stocks, even among firms with well-staffed research facilities.<sup>37</sup>

Characteristic of the printed materials and advertising of the broker-dealer and publishing firms in all of the categories mentioned was the assertion or suggestion that their advisory output was the product of "research."<sup>38</sup>

Somewhat paradoxically, the Study shows that the investors most in need of responsible assistance receive it, in most instances, the least. The larger institutional investors, who employ their own expert advisory personnel, insist upon and receive detailed reports from skilled securities analysts.<sup>39</sup> Other investors, for the most part, receive the brief conclusory recommendations formulated in the manner mentioned above,<sup>40</sup> with no hint as to the manner in which they were originated.<sup>41</sup>

The existence of such striking disparities in advisory procedures may be accounted for in several ways. Although the use of "research" to obtain business is a "competitive necessity,"<sup>42</sup> the costs of staffing experienced, skilled personnel in adequate numbers is considerable.<sup>43</sup> In such a situation, the nature of the advisory communication makes it relatively easy, and tempting, to cut corners by using the "research" product of over-extended and unqualified personnel.<sup>44</sup> Any hesitation in economizing in this way, and any doubts about the propriety of doing so, are likely to be fleeting when legal responsibilities are, as the Study noted, "cloudy."<sup>45</sup> As a consequence, guidelines for the formulation and communication of market advice, especially the former, are largely a matter of intra-firm standards.<sup>46</sup> When these standards tolerate inexperienced, unsupervised personnel, indiscriminate use of unverified advisory "information," and the favored treatment of certain categories of customers, the firm is, after all, merely doing what most others do.

Broker-dealers, it is true, do profess concern for the impact of the "suitability" rule at the communication stage.<sup>47</sup> The "suitability," or "know-your-customer," rule of both the exchanges and the NASD

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37. See especially comments in *Special Study* 344; note 32 *supra*.

38. *Special Study* 248, 323, 352, 355-56, 367, 384. See also *id.* at 368-69, 379.

39. *Special Study* 357. See also note 30 *supra*.

40. *Special Study* 349, 357, 374. See also note 30 *supra*.

41. *Special Study* 349, 355-58, 384. See also note 34 *supra*.

42. *Special Study* 330-31, 344-45, 350, 351, 383.

43. See notes 27-30 *supra* and note 45 *infra*.

44. See notes 28-31 *supra*.

45. *Special Study* 386. See also *id.* at 356 n.253.

46. See note 23 *supra*.

47. *Special Study* 298-99.

requires that the salesman select for recommendation a stock that is suitable for a person in the financial position of the customer.<sup>48</sup> Developed to control abuses in the selling practices of securities salesmen, this rule has not been thought of as imposing standards of skill and care in securities analysis, although it is perhaps logically susceptible to such an extension.<sup>49</sup>

The picture which emerges from the Special Study findings is one of vast advisory activity by both the competent and the incompetent, who work in many cases for seriously understaffed firms that are attempting to respond to the competitive need to keep up a constant flow of recommendations. This takes place in an atmosphere conspicuously lacking in standards for advisory conduct; it is hardly surprising that investors<sup>50</sup> and, although the extent is not easy to gauge, the economy<sup>51</sup> suffer.

#### IV. CONTROLS FOR INVESTOR PROTECTION AT THE TIME OF THE SEC SPECIAL STUDY

The Study shows unmistakably that a great deal of inexcusably irresponsible advice comes from those in the advisory business. Why isn't this prevented, either by the competitive forces of the market place or by regulation?<sup>52</sup>

Competitive forces seem to have little effect. One probable reason is that the results of investment advice are so intermixed with cyclical trends that few investors can tell whether they were irresponsibly advised or whether they were caught in a disaster which wisdom would not have avoided. Another reason may be the complexity of the advisory process itself. In any event, nearly everyone seems to concede that regulation is necessary; the question arises as to why it is not more effective. I will survey the three principal instruments of regulation under these headings: self-regulatory organizations; federal regulation; and state securities legislation and the common law of fraud.

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48. *Id.* at 298-99. In the case of the NYSE it is referred to as the "know your customer rule." NYSE Rule 405(1), CCH NYSE GUIDE ¶ 2405 (1960); see *Special Study* 315-16.

49. See Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, (1965) DUKE L.J. 445; with respect to the current furor in the "suitability" area, see N.Y. Times, Jan. 9, 1967, p. 44, col. 7.

50. *Special Study* 269-72, 324-26, 342-44, 386.

51. *Id.* at 9-11, 386.

52. There were, of course, notable illustrations of sound research and advisory practices with desirable competitive results. See *id.* at 353, 365.

A. *The Self-Regulatory Organizations*

The memberships of the self-regulatory organizations—the exchanges and the NASD—comprise, for the most part, individuals and firms who do not *sell advice*; they are in the business of selling stocks. These organizations quite obviously view the advisory activities of member firms as a free, fringe service in a selling operation, and consider the quality of the advice offered to be largely a matter of individual firm standards.<sup>53</sup> They do, however, accept some responsibility for peripheral matters: there are rules and guidelines to prevent abuses in connection with discretionary accounts,<sup>54</sup> to prevent violation of the “suitability rule,”<sup>55</sup> and to prevent the use of lurid, flamboyant, or factually misleading language in printed advisory materials, newspaper ads, and the like, which are referred to by the self-regulatory organizations as “advertising materials.”<sup>56</sup> While these rules and guidelines have had a wholesome impact upon the communication stage of investment advice, the Special Study findings point up the remarkable extent to which they leave untouched certain aspects of the advisory process important to the quality of the advisory output.<sup>57</sup>

The rules and guidelines of these self-regulating groups are policed by periodic examinations of the printed advisory materials used by the members and by the investigation of public complaints.<sup>58</sup> The very infrequent disciplinary proceedings dealing with advisory activities are almost entirely concerned with such infractions as factual inaccuracy and the recommendation of “unsuitable” securities.<sup>59</sup> In addition, the inspection of printed materials provokes occasional general criticism as to their content.<sup>60</sup> Although under a statutory mandate imposed by the Securities Exchange Act of 1934<sup>61</sup> to assure “just and equitable principles of trade,” these groups simply have not acknowledged their responsibility for the quality of what passes as investment advice.<sup>62</sup> The enormous increase in recent years both in the volume of advisory activity and in its use to get business has brought with it no change in attitude.<sup>63</sup> Certainly there seems to

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53. *Id.* at 379 (NYSE), 380 (NASD).

54. *Id.* at 309, 315.

55. *Id.* at 298-99, 311-12, 315, 320. See also note 49 *supra*.

56. *Special Study* 244, 316, 376-81.

57. See *Special Study* 385-86; note 29 *supra*.

58. *Special Study* 377-79, 308-21.

59. *Id.* at 309-13, 320-21, 376-81.

60. See note 56 *supra*.

61. Exchange Act §§ 6b, 15A(b)8; 2 Loss 1176, 1363-78.

62. *Special Study* 145, 158, 379, 385-86.

63. *Ibid.* Figures as to growth may be found in *id.* at 21, 244-48, 330-31.

be an inconsistency between this "hands-off" approach and other official activities of the self-regulatory organizations, such as suggesting that member firms use "research" to attract business and distributing to them advertising material urging the relatively unsophisticated investor to "Buy a Share in America."<sup>64</sup>

### B. Federal Regulation

A good deal more important are the federal controls. In a comprehensive scheme one might expect to find controls undertaking each of the following: (1) the determination of who may engage in advisory activity ("entry standards"); (2) the prohibition of certain acts and practices; (3) the assurance of access by the public to information needed in securities analysis; and (4) the establishment of general standards for advisory conduct.

Entry standards require little comment: at the time of the Special Study the entry threshold was very low, particularly in the advice area.<sup>65</sup> Prohibited acts and practices are of limited present significance,<sup>66</sup> except perhaps with respect to advertising conduct by those selling advice.<sup>67</sup> Federal regulation relies most heavily on the other two types of controls: the imposition of reporting requirements on security issuers, and the development of general standards for advisory conduct. The former is the subject of much consideration elsewhere,<sup>68</sup> while the latter has become the target of the SEC's so-called "anti-fraud rules." This development will be dealt with in some detail.

#### 1. Background

At a very early stage the SEC seems to have decided that simply to prohibit specific practices considered deceptive or fraudulent was not enough.<sup>69</sup> There was need of a framework for the development and implementation of "general standards,"<sup>70</sup> presumably compa-

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64. As to the former, see *id.* at 244-45, 379; as to the latter, see *id.* at 246. See also note 63 *supra*.

65. *Special Study* 145, 158. See also *id.* at 125, 142. This subject is given considerably more attention in the text accompanying note 279 *infra*.

66. *Special Study* 375-76; with respect to other types of conduct, see *id.* at 302-08. See also Cohen & Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROB. 691, 698 (1964) [hereinafter cited as Cohen & Rabin].

67. *Special Study* 381-83. But see *id.* at 367-69.

68. 1 Loss 159-78; with respect to reporting requirements under the 1964 amendments, see BAKER & CARY, CORPORATIONS 9-12 (Supp. 1965).

69. Duker & Duker, 6 S.E.C. 386, 388-89 (1939). See also Mac Robbins & Co., Securities Exchange Act Release No. 6846, at 3 (July 11, 1962).

70. See Cohen & Rabin 702-03.

rable to those developed in the professions,<sup>71</sup> where the norms of conduct call for special competence and have considerable ethical content.<sup>72</sup> The SEC has sought to develop what it refers to as "professional standards" for investment advisers by elaboration of the "fraud" notion.<sup>73</sup> That it should at the outset have adopted this approach is not surprising: while the federal securities legislation did not give an express mandate to establish standards for advisory conduct, and while it was not at all clear that the SEC would be on firm ground in insisting that the self-regulatory organizations adopt them,<sup>74</sup> the SEC was, on the other hand, given extensive jurisdiction with respect to "fraud."<sup>75</sup>

The approach the SEC has followed is grounded in three sections of the securities acts<sup>76</sup> which, in broad, and for the most part vague, language about misrepresentation and manipulation prohibit what the SEC and the courts habitually refer to as fraud.<sup>77</sup> Using its rule-making authority, the SEC has adopted a rule containing much the same language.<sup>78</sup> It usually enforces these statutory provisions and this rule in quasi-judicial proceedings in which it writes opinions stating its findings and conclusions. In its opinions, it customarily relies upon these three statutory sections and this rule collectively, referring to them as the "anti-fraud provisions."<sup>79</sup>

One must turn to this "administrative common law" to get an insight into the development of general standards of conduct relat-

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71. See in this connection, *A Symposium on Professional Negligence*, 12 VAND. L. REV. 535 (1959).

72. 12 ENCYCLOPEDIA OF THE SOCIAL SCIENCES 476 (1934). See also *Special Study* 240-42 (discussing "professionalism") and 237-38; Cohen & Rabin 702-05; text accompanying note 85 *infra*. For suggestions that "fraud" does not encompass all forms of unethical conduct, see Herrick, Waddell & Co., 25 S.E.C. 437, 445-46 (1947); Valley Forge Sec. Co., Securities Exchange Act Release No. 7055, at 4 (Apr. 12, 1963).

73. *Special Study* 238-42; Cohen & Rabin 702-03; Levin & Evan, *Professionalism and the Stock Broker*, 21 BUS. LAW. 337 (1966).

74. While the responsibilities of the self-regulatory groups are couched in broad and sweeping terms (see generally 2 Loss 1168-72, 1359-64, 1387, and Cohen & Rabin 707) and there are sweeping statements concerning the SEC's rule-making authority as to selling practices (see Cohen & Rabin 696-98), the SEC has approached the "general standards" problem from a "fraud" perspective. See *Special Study* 375; Cohen & Rabin 702. Perhaps this explains the assumed need for new legislation to implement certain of the *Special Study* recommendations. See notes 279 & 296 *infra*.

75. Cohen & Rabin 696, 702.

76. Securities Act of 1933 § 17a, 48 Stat. 74, as amended, 15 U.S.C. §§ 77a-aa (1964) [hereinafter cited as Securities Act]; Exchange Act §§ 10b & 15c.

77. See opinions cited in the several subsections which follow. See also Cohen & Rabin 702, 696. For a discussion of the sections and their differences, see 3 Loss 1421-44; Mac Robbins & Co., Securities Exchange Act Release No. 6846, at 2 n.5 (July 11, 1962).

78. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5. For a comparison of this Rule with the other "fraud" provisions, see note 77 *supra*.

79. See note 77 *supra*.

ing to investment advisers.<sup>80</sup> This development has been a gradual one, and for the most part has taken place outside the courts;<sup>81</sup> during its course, a group of distinguishable regulatory theories or concepts have evolved from these anti-fraud provisions. It is the SEC's practice to rely upon several of such theories in the same proceeding, but for discussion purposes it is necessary to treat them separately.<sup>82</sup> Most of the proceedings have involved the broker-dealer firms, who make no charge for most of their advice. However, the "anti-fraud provisions" also apply to those offering advice for a fee.<sup>83</sup>

## 2. Failure to Deal "Fairly" and in Accordance with "Standards of the Profession"

The fraud theories which might at first blush appear to have the broadest effect in the development of standards of conduct might be called "Shingle Theory No. 1" and "Shingle Theory No. 2." As the Commission has stated in numerous opinions, those who offer investment advice (and who thus, as it were, hang out a "shingle," as professional men have been known to do), thereby hold themselves out to be advisers who will deal "fairly"<sup>84</sup> (Shingle Theory No. 1), and who will adhere to the "standards of the profession" to which they belong<sup>85</sup> (Shingle Theory No. 2). Failure to deal "fairly" or to meet

80. See generally FRIENDLY, *THE FEDERAL ADMINISTRATIVE AGENCIES—THE NEED FOR BETTER DEFINITION OF STANDARDS* (1962); Baker, *Policy by Rule or Ad Hoc Approach—Which Should It Be?*, 22 LAW & CONTEMP. PROB. 658 (1957); Cary, *Administrative Agencies and the Securities and Exchange Commission*, 29 LAW & CONTEMP. PROB. 653 (1964).

81. See text accompanying notes 154 & 184 *infra*. Compare Cohen & Rabin 695, 710-14. See also MUNDHEIM, *DUKE UNIVERSITY SCHOOL OF LAW CONFERENCE ON SECURITIES REGULATION* 80-81 (1965).

82. While the SEC often refers collectively to the "antifraud rules" (see note 79 *supra*), it is obvious, at least at the verbal level, that the various rules embody different theories. But where, as is often the case, the SEC relies upon several of the rules in condemning the course of conduct in question, it is difficult to determine the extent to which the SEC is relying on any one rule. See Cohen & Rabin 702-08. See also Lesh, *Federal Regulations of Over-the-Counter Brokers and Dealers in Securities*, 59 HARV. L. REV. 1237 (1946), for a detailed examination of the early development of several of these approaches with emphasis upon the "agency" or "fiduciary" theory.

83. See Anne Caseley Robin, *Investment Advisers Act Release No. 149*, at 3 (Sept. 10, 1963); *Special Study* 381-83; 3 LOSS 1515-18. The question would be whether this group owes a "higher duty." See text accompanying note 99 *infra*.

84. Shearson, Hammill & Co., *Securities Exchange Act Release No. 7743*, at 14 (Nov. 12, 1965). See also Heft, Kahn & Infante, Inc., *Securities Exchange Act Release No. 7020*, at 4 (Feb. 11, 1963); Harold Grill, *Securities Exchange Act Release No. 6989* (Jan. 8, 1963); N. Pinsker & Co., *Securities Exchange Act Release No. 6401*, at 6 (Oct. 21, 1960); Barnett & Co., *Securities Exchange Act Release No. 6310*, at 4 (July 5, 1960); Cohen & Rabin 703.

85. Illustrative cases are Mac Robbins & Co., *Securities Exchange Act Release No. 6846*, at 3 (July 11, 1962); Best Sec., Inc., *Securities Exchange Act Release No. 6282*, at 3 (June 3, 1960); William Harrison Keller, Jr., 38 S.E.C. 900, 905 (1959). See also Carl J. Bleidung, 38 S.E.C. 518, 521 (1958); Cohen & Rabin 703.

"standards of the profession" is "fraud." The two theories often are lumped together in discussing a finding of fraud, but in numerous instances are relied upon individually.<sup>86</sup>

The shingle theories are considered to have met with judicial approval in the *Charles Hughes* case decided in 1943,<sup>87</sup> one of two key court opinions upon which the SEC customarily relies to support its fraud approach in the securities field generally.<sup>88</sup> There, the Court of Appeals for the Second Circuit, in affirming the SEC's revocation of a broker-dealer's registration, accepted the SEC's contention that the sale of securities by a dealer acting as principal (rather than as agent) carried with it an implied representation that the price was reasonably related to the prevailing market price. In this situation, a dealer who solicits business "holds itself out as competent to advise in the premises,"<sup>89</sup> and if the price is unreasonably in excess of market price there has been both "an omission to state

86. In some instances the conduct is said to be "neither fair *nor* in accordance with the standards of the profession." See, e.g., *Best Sec., Inc.*, Securities Exchange Act Release No. 6282 (June 3, 1960). (Emphasis added.) Where a "standard" is available (see text accompanying note 273 *infra*), the two notions, "standard" and "fairness," may be coupled. See cases cited note 85 *supra*. But where, as is often the case, there is no "industry standard" to point to, the emphasis is upon "fairness." See, e.g., *Heft, Kahn & Infante, Inc.*, Securities Exchange Act Release No. 7020, at 4 (Feb. 11, 1963); *Harold Grill*, Securities Exchange Act Release No. 6989 (Jan. 8, 1963); *Barnett & Co., Inc.*, Securities Exchange Act Release No. 6310, at 4 (July 5, 1960); *Leonard Burton Corp.*, Securities Exchange Act Release No. 5978, at 5 (June 4, 1959). In this connection, see *Cohen & Rabin 703* ("will deal fairly with his customers in accordance with the standards of the professions"). (Emphasis added.) However, in some of the situations in the cited opinions "standards" are now available. See text accompanying note 273 *infra*.

While at the outset the SEC did not trace the origin of the "fairness" notion to the role of "fairness" in the activities of the self-regulatory groups, see *Duker & Duker*, 6 S.E.C. 386 (1939), today it might call attention to the National Association of Securities Dealers' "Rules of Fair Practice." NATIONAL ASSOCIATION OF SECURITIES DEALERS, NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL, art. III, § 1, at D-5 ("a member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade"). The SEC might also find this approach awkward because of reference to the Association's "Interpretations" which read as follows:

The Securities and Exchange Commission has also recognized that brokers and dealers have an obligation of fair dealing in actions under the general anti-fraud provisions of the Federal securities laws. The Commission bases this obligation on the principle that when a securities dealer opens his business he is, in effect, representing that he will deal fairly with the public. Certain of the Commission's cases on fair dealing involve practices not covered in the foregoing illustrations.

*Id.* at G-9. See also *MUNDHEIM*, *supra* note 81, at 75-90; note 72 *supra*.

87. *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944). For a valuable examination of this and earlier Commission action in the fraud area, see *Lesh*, *supra* note 82, at 1255. A recent summary by the SEC of the "shingle" theory appears in *Mac Robbins & Co.*, Securities Exchange Act Release No. 6846, at 2 (July 11, 1962).

88. See, e.g., *Mac Robbins & Co.*, *supra* note 87, at 3. See also *Cohen & Rabin 703*. For the other leading case, see text accompanying note 184, *infra*.

89. 139 F.2d at 436-37. In this connection the court drew attention to the "confidence . . . established" as a result of the adviser's "expert knowledge and proffered advice." *Id.* at 437.

a material fact and a fraudulent device”<sup>90</sup> within the language of the anti-fraud rules. The court noted the SEC’s reliance upon NASD rules, as well as upon certain interpretations of state “Blue Sky” legislation, in determining what mark-up is reasonable.<sup>91</sup> Most significantly, the court cited SEC opinions dealing with mark-ups in which the SEC had spoken of “the vital representation that the customer will be dealt with fairly, and in accordance with standards of the profession.”<sup>92</sup> It may be doubted whether the court in referring to these decisions intended to endorse this vague and sweeping statement of the obligations of those in the securities business.<sup>93</sup> Indeed, it appears that the SEC itself was unwilling to push the notion too far at the outset.<sup>94</sup> Whatever the intent, it is abundantly clear that the SEC considered *Hughes* to have given judicial approval to these “shingle” theories.<sup>95</sup>

This is not the place for an exhaustive examination of these two interesting fraud concepts.<sup>96</sup> In addition to their effect on investment advice they have played a major role in SEC control of broker-dealer conduct.<sup>97</sup> In the advice area they have been obstacles which might have deterred the less optimistic. The SEC’s own opinions have been the principal source of “fairness” norms; no productive outside source has appeared to give substance to Shingle Theory No. 1. Moreover, the dearth of industry “standards” (particularly with respect to the formulation stage of the advisory process),<sup>98</sup> already noted in the discussion of the Special Study findings,<sup>99</sup> might have been a handicap in the use of Shingle Theory No. 2. Yet the absence of “industry” or

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90. *Id.* at 437.

91. *Id.* at 436 n.1.

92. Duker & Duker, 6 S.E.C. 386, 388 (1939), used the quoted phrase. See also Guaranty Underwriters, Inc., 14 S.E.C. 271, 280 (1943).

93. See text accompanying note 136 *infra*.

94. Allender Co., 9 S.E.C. 1043, 1057 (1941). For other early and interesting versions, see Lawrence R. Leeb, 13 S.E.C. 499, 505 (1943) (“because of the confidential relationship between dealer and client we have repeatedly regarded . . .”); Trost & Co., 12 S.E.C. 531, 535 (1942) (“decent standards”); William J. Stelmack Corp., 11 S.E.C. 601, 622 (1942) (“when a dealer is aware that such is not the case, the representation is fraudulent”).

95. See note 88 *supra*. See also MUNDHEIM, *supra* note 81, at 75-90.

96. Compare the discussion of “professional obligations” of other groups in *A Symposium on Professional Negligence*, *supra* note 71.

97. See illustrations in Mac Robbins & Co., Securities Exchange Act Release No. 6846, at 3 (July 11, 1962); Cohen & Rabin 704-08.

98. See text accompanying note 46 *supra*. The “suitability” rule is an example of a well-established standard in the selling practice area upon which both the SEC and the industry rely. See text accompanying notes 47 & 48 *supra*. See also Barnett & Co., Securities Exchange Act Release No. 6310, at 4 (July 5, 1960); Best Sec. Inc., Securities Exchange Act Release No. 6282, at 3 (June 3, 1960).

99. See text accompanying notes 18 & 46 *supra*.



"fairness" standards does not seem to have embarrassed the SEC;<sup>100</sup> rather, it has found it possible to find violations of these theories in situations where an impartial observer might have thought that none was identifiable or discernible, and where the conduct complained of was merely a failure to meet minimum standards in evaluating and recommending stocks.<sup>101</sup>

These fraud theories suggest a fundamental jurisdictional problem which also arises in connection with other theories to be discussed later: To what extent is the SEC justified in undertaking to develop general professional standards by manipulation of the concept of fraud?<sup>102</sup> As the SEC seems to recognize,<sup>103</sup> standards which afford adequate investor protection must speak to care and skill, as well as to ethics. The former are elements of due care which the law of negligence imposes upon professionals and persons undertaking tasks requiring special skills.<sup>104</sup> The dual nature of this obligation of due care is emphasized by those concerned with the problems of professional responsibility, as the following statement by Dean John Wade, an authority in the field, indicates:

In determining whether an ordinary individual is negligent in causing injury to another, the standard of care is usually expressed in a simple fashion by speaking of what a reasonably prudent person would do under similar circumstances. The standard in the case of an attorney [or accountant] is somewhat more complicated. It is composed of at least two elements and possibly three. The first has to do with the *care and diligence which he must exercise*. The second is concerned with the *minimum degree of skill and knowledge* which he must display. The third may involve an additional skill which he may himself possess.<sup>105</sup>

100. On occasion the SEC has shown a willingness to look around. See *Richmond Corp.*, Securities Act Release No. 4584 (Feb. 27, 1963) (scholarly writings; testimony of leaders of large firms as to what is required by "fair" dealing); *William J. Stelmack Corp.*, 11 S.E.C. 601, 621-24 (1942) (state legislation; National Association of Securities Dealers' "Rules of Fair Practice"—with respect to the latter, see note 87 *supra*). See also *Duker & Duker*, 6 S.E.C. 386, 388-89 (1939) (state and federal decisions; treatises on trust law); *MUNDHEIM*, *supra* note 81, at 75-90; note 290 *infra*.

101. See, e.g., *Shearson, Hammill & Co.*, Securities Exchange Act Release No. 7743, at 18 (Nov. 12, 1965); *Alexander Reid & Co.*, Securities Exchange Act Release No. 6727, at 5 n.10 (Feb. 8, 1962). Contributing to the analytical problems in this area is the SEC's custom of relying upon several fraud theories in condemning the conduct in question without disclosing the degree to which they are relying on any specific theory. Illustrative of this tactic is *N. Pinsker & Co.*, Securities Exchange Act Release No. 6401, at 6-8 (Oct. 21, 1960).

102. The SEC makes no bones about its objectives. Cf. *Valley Forge Sec. Co.*, Securities Exchange Act Release No. 7055, at 3 (Apr. 12, 1963). See also *Cohen & Rabin* 702-03.

103. See particularly text accompanying notes 119 & 156 *infra*.

104. *A Symposium on Professional Negligence*, *supra* note 71, at 762. See also *Hawkins*, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797, 812-21 (1959).

105. *A Symposium on Professional Negligence*, *supra* note 71, at 762. (Emphasis added.)

By reading into the advisory communication an implied assertion that due care and skill have been used—and that this is what is being done comes through more clearly in the consideration of other fraud theories<sup>106</sup>—negligence is made to equal fraud. The propriety of this has vexed the common law since *Derry v. Peek*.<sup>107</sup> How far may the SEC go in this direction, when it was not given an express mandate to establish or implement standards, but was rather given jurisdiction only to prevent and to act against deceptive conduct and manipulation? The answer to this question is, of course, a matter of statutory interpretation. But when, as here, legislative history is not very helpful,<sup>108</sup> *Derry v. Peek* lurks in the background,<sup>109</sup> as the SEC, on occasion, appears to be aware.<sup>110</sup> The question that case raised and answered in the negative is whether a common-law fraud action will lie for misrepresentation in the absence of proof of a conscious knowledge ("scienter") that the statement complained of was untrue.<sup>111</sup> A good many common-law courts have gotten around *Derry v. Peek* by treating indifference to the correctness of the assertion as adequate to prove scienter.<sup>112</sup> In some cases where negligent misrepresentation is complained of courts have been able to avoid the scienter problem by allowing the pending action to sound in "negligence" rather than in "fraud,"<sup>113</sup> a technique seemingly not available to the SEC. There are, however, courts which have been willing to treat negligence as fraud, an approach which has been criticized as unwisely confusing two areas of the law having different origins and different underlying policy considerations.<sup>114</sup> When this question of the need to prove scienter

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106. See text accompanying notes 119 & 156 *infra*.

107. 14 App. Cas. 337 (1889). For a recent discussion of the *Derry v. Peek* problem, see Hawkins, *supra* note 104, at 813-21.

108. See 3 Loss 1430-44; Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 NW. U.L. REV. 185 (1964). See also Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 234-42 (1933).

109. See, e.g., 3 Loss 1444. See also text accompanying note 220 *infra*.

110. See Mac Robbins & Co., Securities Exchange Act Release No. 6846, at 4 n.16 (July 11, 1962); Alexander Reid & Co., Securities Exchange Act Release No. 6727, at 5 (Feb. 8, 1962). It was, perhaps, less of a problem in some of the earlier opinions where the point is made that the conduct is "knowingly undertaken." E.g., Guaranty Underwriters, Inc., 14 S.E.C. 271, 280 (1943); W. K. Archer, 11 S.E.C. 635, 645 (1942); William J. Stelmack Corp., 11 S.E.C. 601, 621-22 (1942); Duker & Duker, 6 S.E.C. 386, 389 (1939). See also note 171 *infra*.

111. See *Knickerbocker Merchandising Co. v. United States*, 13 F.2d 544 (2d Cir. 1926). See also note 150 *infra*.

112. See PROSSER, *TORTS* 719-24 (3d ed. 1964).

113. *Ibid.* See also Hawkins, *supra* note 104, at 812-21; Shulman, *supra* note 108, at 234-35.

114. Bohlen, *Should Negligent Misrepresentations Be Treated as Negligence or Fraud?*, 18 VA. L. REV. 703 (1932); Shulman, *supra* note 108, at 235. As Professor Bohlen points out, problems arise in several areas, e.g., burden of proof, contributory negligence as a defense, and the right to punitive damages.

has arisen in cases where an individual asserts a private cause of action based upon the anti-fraud provisions under discussion, the courts have not been able to agree.<sup>115</sup>

There is, of course, abundant authority for the general, and vague, proposition that the anti-fraud provisions were not intended to limit the SEC's jurisdiction to conduct fraudulent at common law.<sup>116</sup> Beyond that, about all that can be said with certainty is that there are judicial indications that the SEC is not free to define "fraud" so as to proscribe any conduct it deems reprehensible,<sup>117</sup> a proposition with which the SEC on occasion seems to agree.<sup>118</sup> Yet, as will be seen, there are an increasing number of proceedings in which negligence in advisory conduct is found to violate the "anti-fraud rules."

### 3. Absence of an "Adequate and Reasonable" Basis

Particularly in the situation where the allegedly fraudulent statement was a "prediction" or "favorable recommendation," the SEC has used another formula which I shall call "Shingle Theory No. 3": there is an implied representation that an "adequate" or "reasonable" basis exists for the statement.<sup>119</sup> When there is no adequate or reasonable basis, "fraud" can be avoided, if at all,<sup>120</sup> only by disclosure of information about the risks involved.

In several opinions dealing with this subject, the SEC had used language suggesting that fraud resulted from a failure to evaluate properly and disclose "known facts which make a prediction dangerous and unreliable"<sup>121</sup> or, possibly even where such facts if not "known," were "easily ascertainable."<sup>122</sup> In more recent opinions,

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115. See text accompanying note 218 *infra*.

116. See 3 Loss 1430-44 and authorities cited therein.

117. See text accompanying note 139 *infra*.

118. See note 111 *supra* and text accompanying note 290 *infra*.

119. Earlier decisions speak of what the prediction "implied." *E.g.*, Leonard Burton Corp., Securities Exchange Act Release No. 5978, at 4 (June 4, 1959). But later opinions add language reminiscent of that found in Shingle Theories 1 and 2: "inherent in the dealer-customer relationship [is] the implied representation . . . that representations respecting a stock . . . are reasonably made on the basis of knowledge and careful consideration." Heft, Kahn & Infante, Inc., Securities Exchange Act Release No. 7020, at 4 (Feb. 11, 1963). See also Alexander Reid, Securities Exchange Act Release No. 6727, at 5 (Feb. 8, 1962); MUNDHEIM, *supra* note 81, at 75-90; Cohen & Rabin 704.

120. There have been suggestions that "disclosure" will not, in all cases, avoid "fraud." See Cohen & Rabin 703.

121. Leonard Burton Corp., Securities Exchange Act Release No. 5978, at 4 (June 4, 1959).

122. N. Pinsker & Co., Securities Exchange Act Release No. 6401, at 6 (Oct. 21, 1960); Barnett & Co., Securities Exchange Act Release No. 6310, at 4 (July 5, 1960); Best Sec., Inc., Securities Exchange Act Release No. 6282, at 4 (June 3, 1960).

such as *In re Mac Robbins*,<sup>123</sup> a change in emphasis is discernible. This case is interesting, also, because it shows the trouble even sophisticated courts have with the theory, particularly when, as is the SEC's wont, the theory is interwoven with several others.<sup>124</sup>

In *Mac Robbins*, highly optimistic statements were made orally and in distributed brochures about an issuer in the bowling industry. No mention was made of the fact that the issuer was operating at a loss. The SEC found that the statements violated the "anti-fraud" provisions because they were made without "an adequate and reasonable basis" for them.<sup>125</sup> Several *Mac Robbins*' salesmen were made parties to the proceeding, including a Mr. Berko and a Mr. Kahn whose conduct was found to be the "cause" of the revocation of *Mac Robbins*' registration.<sup>126</sup> The principal charge against Kahn seems to have been that there was no "adequate basis" for "optimistic statements as to stock of a new company without disclosing there was no information available as to whether it has operating profits or losses at the time."<sup>127</sup> The record showed that accounting figures as to the financial condition of the issuer were not available when Kahn made the objectionable statements.<sup>128</sup> Thus, the critical "omission" was failure to reveal pertinent but *unavailable* information rather than, as in earlier opinions, "known or easily ascertainable facts."<sup>129</sup>

Berko, the SEC stated, "predicted Sports would rise [from 7] to 15 within a year" when there "was no adequate basis for this statement because Sports, a firm in business for approximately one year, was suffering initial operating losses. Petitioner should have known of the losses and disclosed them."<sup>130</sup> Unlike the findings with respect to facts available when Kahn acted, the record indicated that finan-

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123. The proceeding was before both the SEC and the courts on two occasions. Citations to the various stages are found in their chronological treatment in the text.

124. See cases cited note 82 *supra*.

125. *Mac Robbins & Co.*, Securities Exchange Act Release No. 6462 (Feb. 6, 1961).

126. *Id.* at 10.

127. *Kahn v. SEC*, 297 F.2d 112, 113 (2d Cir. 1961). The other had to do with "comparisons" of the securities of the subject issuer with those of other corporations. *Id.* at 114.

128. *Kahn v. SEC*, 297 F.2d 112, 113 (2d Cir. 1961).

129. See text accompanying note 122 *supra*.

130. *Berko v. SEC*, 297 F.2d 116, 117 (2d Cir. 1961). In the court's summary of the SEC's "ultimate conclusion" ("or they were grossly careless or indifferent as to the existence of an adequate basis . . ."), it appears to have lost sight of the interesting distinction which the SEC makes between conduct which is "fraud" and a finding that the violations were "willful" within the meaning of § 15b of the Securities Exchange Act. *Mac Robbins & Co.*, Securities Exchange Act Release No. 6462, at 8 n.22 (Feb. 6, 1961); 2 Loss 1307-12.

cial statements were available when Berko made the predictions in question.<sup>131</sup>

Both Kahn and Berko appealed to the Court of Appeals for the Second Circuit. In its argument to that court, the SEC pressed the contention that its fraud findings were justified because of the "boiler-room" nature of the selling and advisory activity in question<sup>132</sup> even though its opinion had strongly emphasized the "absence of an adequate or reasonable basis" theory.<sup>133</sup> The court, in remanding both cases to the SEC for clarification, rejected the SEC decision, asserting that "affirmance of its findings and reasoning would establish a rule applicable to all sales of securities."<sup>134</sup> It added this admonition: "Basically, its [the SEC's] goal should be clarification of the legal duties imposed on salesmen involved in operations such as Mac Robbins, Inc."<sup>135</sup>

Judge Charles Clark, who wrote for the court in *Charles Hughes* (the original "shingle" case),<sup>136</sup> concurred in the remand of both appeals in an opinion in which he stated:<sup>137</sup>

Basically the question is the extent to which it would press the conclusion of fraud which we supported in *Charles Hughes & Co. v. S.E.C.* . . . The Commission is relying on the so-called "shingle" theory to establish statutory fraud. The essence of this theory is that in certain circumstances one who sells securities to the public—who hangs out his shingle—implicitly warrants the soundness of statements of stock value, estimates of a firm's earnings potential, and the like. When such a person conceals known information inconsistent with this "implicit warranty of soundness" he has omitted a material fact without which the statements made would be misleading. See 3 Loss, *Securities Regulation* 1490 (2 ed. 1961). One element of this warranty, the Commission held below, is that all such statements, or at least highly optimistic ones, have an "adequate basis." If the salesman makes statements, knowing they had no adequate basis, or if he is "grossly careless or indifferent to the existence of an adequate basis" for his statements, then he has violated the anti-fraud provisions, principally § 17(a)(2) of the Securities Act of 1933, 15 U.S.C. § 779(a)(2).

Despite protestations to the contrary,<sup>138</sup> Judge Clark's recapitula-

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131. *Berko v. SEC*, 297 F.2d 116, 117 (2d Cir. 1961).

132. 297 F.2d 116, 117; 297 F.2d 112, 113.

133. *Mac Robbins & Co.*, Securities Exchange Act Release No. 6462, at 6-7 (Feb. 6, 1961). The "boiler-room" aspect appears on page 8 of the opinion.

134. 297 F.2d 116, 118. See also 297 F.2d 112, 113.

135. 297 F.2d 116, 119. See also 247 F.2d 112, 114.

136. See text accompanying note 87 *supra*.

137. 297 F.2d 112, 115.

138. *Cohen & Rabin* 711 n.156. See also *Mac Robbins & Co.*, Securities Exchange Act Release No. 6864, at 2-4 (Feb. 6, 1961).

tion of the "shingle" theory must have caused some concern in the SEC.<sup>139</sup> By requiring "knowledge" of "no adequate basis" or "gross carelessness or indifference," the ordinary negligent misrepresentation does not constitute fraud; this keeps the fraud concept largely in line with common-law authorities.<sup>140</sup> However, the SEC has often failed to make clear that it was basing its "fraud" conclusion upon a finding of the kind required by Judge Clark.<sup>141</sup>

Following the remand by the court, the SEC again considered the charges; it departed from its earlier approach and, incorporating the argument it had pressed in the Court of Appeals, wrote an opinion which emphasized the "boiler-room" nature of the operation involved, indicating that it violated Shingle Theory No. 1.<sup>142</sup> At the same time, the SEC managed to convey the idea that it was not modifying or pulling back from its earlier position as to Shingle Theory No. 3. It even stated that, apart from the boiler-room aspects of the activities of Kahn and Berko, a violation of the "adequate or reasonable basis" rule was shown because of their oral recommendations; no mention was made of the type of findings alluded to by Judge Clark.<sup>143</sup>

Only Berko appealed, and the court affirmed.<sup>144</sup> In an opinion not a model of clarity, it agreed with the SEC that a "higher duty to prospective customers" was owed where, as here, a "boiler-room" rather than a legitimate sales operation was involved, emphasizing in this connection the finding that Berko was aware of the "boiler-room" nature of the firm's activity.<sup>145</sup> The court also noted that Berko could have ascertained the firm's financial situation from

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139. This exposition from this particular source could hardly have failed to influence those who decided not to accept the court's challenge and squarely raise the question of how far one can go along the "fraud" route. In any case, the opinion on remand took refuge in the "boiler-room" aspect of the proceeding. See text accompanying note 142 *infra*.

140. See text accompanying note 108 *supra*. Compare MUNDHEIM, *supra* note 81, at 77-78. See also notes 174 & 222 *infra*.

141. See, e.g., Crow, Brouman & Chatkin, Inc., Securities Exchange Act Release No. 7839 (Mar. 15, 1966); Arnold Sec. Corp., Securities Exchange Act Release No. 7813 (Feb. 7, 1966). See also Securities Exchange Act Release No. 6721, at 3 (Feb. 2, 1962); Cohen & Rabin 704-05.

142. Mac Robbins & Co., Securities Exchange Act Release No. 6864, at 4-6, 11-12 (Feb. 6, 1961). See also MUNDHEIM, *supra* note 81, at 89-90.

143. See *id.* at 12-15 (part "V" of the opinion).

144. *Berko v. SEC*, 316 F.2d 137 (2d Cir. 1963).

145. *Id.* at 142. See also MUNDHEIM, *supra* note 81, at 89-90.

146. *Id.* at 142-43.

147. See text accompanying note 135 *supra*. The court did use language which suggests a negligence standard but carefully limited its reasoning to the "boiler-room" context: "He studied, mailed out, and utilized brochures which he should have known and, on proper study, could have determined were deceptive and misleading." 316 F.2d 137, 142.

available financial statements, and, furthermore, could have readily determined that the brochures he distributed contained misleading statements.<sup>146</sup> Clearly, no "clarification of legal duties" of those engaging in advisory conduct, such as the court might have envisaged when it sent the case back to the SEC, came out of this litigation.<sup>147</sup>

In an opinion written shortly after its first opinion in *Mac Robbins*,<sup>148</sup> as well as in several later opinions,<sup>149</sup> the SEC used this "adequate or reasonable basis" approach in a manner which shows even more clearly that advisers can only meet the requirements of the test by the use of diligence and skill in security analysis. Recently, the SEC characterized the implications of this approach in these terms: "that, as a prerequisite [to the avoidance of fraud], he [the adviser] shall have made a reasonable investigation."<sup>150</sup> Also, in what might be called a "shingle on a shingle" theory, it has suggested that Shingle Theory Nos. 1 and 2 encompass an implied representation that Shingle Theory No. 3 has been satisfied.<sup>151</sup>

What this seems to come down to is this: the SEC, when it invokes this theory, will decide whether an investment adviser, adhering to the not too clearly delineated standard of diligence and skill in discovering, analyzing, and evaluating data about a stock of the type recommended, would have said what was said.<sup>152</sup> Thus, a theory which at the outset seems to have been concerned with the fraud notion of "half-truths"—statements which are misleading because of failure to disclose known facts—has evolved with little explanation

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148. Alexander Reid & Co., Securities Exchange Act Release No. 6727 (Feb. 8, 1962).

149. Crow, Brouman & Chatkin, Inc., Securities Exchange Act Release No. 7839, at 9 (Mar. 15, 1966); Shearson, Hammill & Co., Securities Exchange Act Release No. 7743, at 19-20 (Nov. 12, 1965). The cited materials refer to advisory conduct of individual salesmen. The opinions, of course, have numerous other aspects and involve other fraud approaches. See note 82 *supra*.

150. Securities Exchange Act Release No. 6721, at 3, Feb. 2, 1962. See also Cohen & Rabin to the same effect.

151. See *Mac Robbins & Co.*, Securities Exchange Act Release No. 6846, at 4 (July 11, 1962); Alexander Reid & Co., Securities Exchange Act Release No. 6727, at 5 (Feb. 8, 1962). See also *Aircraft Dynamics Int'l Corp.*, Securities Exchange Act Release No. 7113, at 5 (Aug. 8, 1963) ("absent such [adequate] basis, he violated his duty to deal fairly with customers and his implied representation is fraudulent").

In some instances, the SEC has stated that the adviser must have "actual knowledge" of pertinent facts, a test likely to cause some problems for securities analysts. *D. F. Bernheimer & Co.*, Securities Exchange Act Release No. 7000 (Jan. 23, 1963); *Harold Grill*, Securities Exchange Act Release No. 6989, at 4 (Jan. 8, 1963); Alexander Reid & Co., *supra* at 5.

152. See cases cited note 149 *supra*. It seems abundantly clear that the "anti-fraud rules" are not limited in their application to the "boiler-room" situation. Both the cases on point and statements of SEC officials indicate a broader scope of applicability. See Cohen & Rabin. *But see* MUNDHEIM, *supra* note 81, at 77-90; text accompanying note 304 *infra*.

into a broad standard in securities analysis.<sup>153</sup> It is indeed unfortunate that the SEC backed away from the court's invitation, in its first *Berko* opinion,<sup>154</sup> to argue directly that this is a rule of broad application imposing general duties of skill and diligence. Other judicial treatment of the problem has been inconclusive.<sup>155</sup>

#### 4. Failure To Use "Reasonable Care"

A number of proceedings before the SEC have involved the recommendation of stocks which either should have been registered under the 1933 act, or which were registered. Here the SEC has taken the position that the "anti-fraud" provisions impose upon the firm "a duty of reasonable care."<sup>156</sup> The SEC's 1953 decision, *Charles E. Bailey & Co.*,<sup>157</sup> frequently relied upon in later decisions,<sup>158</sup> might be taken as illustrative of this line of decisions in its early form. In that proceeding, the SEC sought revocation of respondent's broker-dealer registration and a determination of whether several named persons engaged in sales activity were the cause of a violation by the registrant. Quite apart from the question of possible unlawful sale of unregistered stock was the additional question of whether the advisory conduct complained of violated the "anti-fraud provisions."<sup>159</sup> The advisory conduct in question consisted of numerous extravagant statements in both sales literature and oral representations aimed at inducing purchases of shares of a corporation which had been operating at a loss and which was entering a new, untried field.<sup>160</sup> The registrant offered as a defense to the inaccurate statements in the sales literature, and in exculpation from the statements of its salesmen, "a preliminary investigation of issuer's affairs" made by visiting its plant, and reliance upon "information furnished by

153. See *Leonard Burton Corp.*, Securities Exchange Act Release No. 5978, at 4 (June 4, 1959).

154. See note 130 *supra*.

155. SEC v. F. S. Johns & Co., 207 F. Supp. 566 (D.N.J. 1962); see SEC v. R. A. Holman & Co., CCH FED. SEC. L. REP. ¶ 91,815 (2d Cir. 1966). See also SEC v. Van Horn, CCH FED. SEC. L. REP. ¶ 91,850 (7th Cir. 1966); *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 264 F.2d 199, 210 (9th Cir. 1959); *Norris & Hirschberg, Inc. v. SEC*, 177 F.2d 228, 233 (D.C. Cir. 1949); SEC v. Broadwell Sec., Inc., 240 F. Supp. 962 (S.D.N.Y. 1965).

156. Illustrative are: *Heft, Kahn & Infante, Inc.*, Securities Exchange Act Release No. 7020, at 4-5 (Feb. 11, 1963); *Keith Richard Sec. Corp.*, Securities Exchange Act Release No. 5988, at 8 (July 17, 1959); *Charles E. Bailey & Co.*, 35 S.E.C. 33, 41-42 (1953). See also Securities Exchange Act Release No. 6721, Feb. 2, 1962 (application of anti-fraud rules generally to sale of, *inter alia*, unregistered securities).

157. *Ibid.*

158. *Ibid.*

159. *Charles E. Bailey & Co.*, 35 S.E.C. 33, 35-43 (1953). Note that the registration provision violation is considered at 43-44.

160. *Id.* at 36-42.



the issuer on which registrant was entitled to rely.”<sup>161</sup> In rejecting the defense the SEC stated: “Such reliance did not constitute discharge of the duty to exercise reasonable care that rested on registrant as underwriter, or a defense to circulation of the materially misleading and deficient statement . . . .”<sup>162</sup>

Opinions such as *Bailey* offer no clue as to the reasoning used in finding that an obligation exists, or, for that matter, the criteria for determining “reasonable care.”<sup>163</sup> In a recent opinion commenting upon *Bailey*, the SEC suggests that the basis for imposition of such a standard is to be found in the “reasonable care” language of sections 11 and 12 of the Securities Act of 1933.<sup>164</sup> These sections provide, *inter alia*, a *private* right of action against those making misrepresentations in registration statements or in the sale of stock required to be registered.<sup>165</sup> The person proceeded against is given a defense by the terms of those sections if he can show that, as to any untrue or omitted fact, he had, “after reasonable investigation, reasonable ground to believe and did believe” it to be true (section 11), or with the exercise of “reasonable care could not have known” of the untruth or omission (section 12).<sup>166</sup> This language has been construed to impose liability for negligence in representations made either in registration statements or the sale of stock required to be registered.<sup>167</sup> The SEC appears to feel that these sections also show an intent to create a duty which it can enforce and which continues for an indeterminate period after the initial sale of the stock;<sup>168</sup> the anti-fraud provisions, which have no comparable language and make no reference to the sections mentioned, were, in the view of the SEC, the intended means of its own implementation of this continuing duty.<sup>169</sup>

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161. *Id.* at 41-42.

162. *Id.* at 42. Its conclusion of a violation of the anti-fraud provisions under discussion is found at 43.

163. In this connection, see text accompanying note 105 *supra*. For example, the SEC apparently has not undertaken to build a record as to what a trained, experienced securities analyst would have done in this situation.

164. *Richmond Corp.*, Securities Act Release No. 4584 (Feb. 27, 1963). With respect to duties imposed upon others in this area, see *Gearhart & Otis, Inc.*, Securities Exchange Act Release No. 7329, at 27 (June 2, 1964) (duty of firms with board representation on the issuer); *Advanced Research Associates, Inc.*, Securities Exchange Act Release No. 7117 (Aug. 16, 1963) (“various relationships”).

165. Securities Act §§ 11 & 12.

166. *Id.* at §§ 11(b)(3)(A)-(D) & 12(2).

167. See 3 Loss 1699-712 & 1724-27 and cases cited therein. The quoted language of the two sections is compared at 1729-31.

168. *Heft, Kahn & Infante, Inc.*, Securities Exchange Act Release No. 7020, at 5 (Feb. 11, 1963) (“thereafter when it was conducting an active retail sales campaign” a “special duty” existed).

169. See *Richmond Corp.*, Securities Act Release No. 7329, at 7 (Feb. 27, 1963).

Were underwriter obligations the subject of this paper, perhaps some question might be raised concerning these obligations which linger on. But what is of interest in considering advisory conduct generally, is an apparent shedding of this underwriter chrysalis. In recent proceedings not involving registration problems, the SEC has begun to speak in terms of a duty of "due diligence and prudence," "a high degree of care," and "diligent inquiry."<sup>170</sup> Yet the characteristic chimerical qualities of the fraud theories reveal themselves in this language, suggesting that this "duty" may, in turn, be subsumed under one or another of the "shingle" theories.<sup>171</sup>

### 5. Recklessness

"Recklessness" is another ground for a finding of fraud mentioned from time to time in SEC opinions.<sup>172</sup> This ground seems more in step with developments in the area of common-law fraud than the theories discussed earlier.<sup>173</sup> Proof of an "I don't care" state of mind is a substitute for scienter even in most of the jurisdictions which continue to follow *Derry v. Peek*.<sup>174</sup> Although courts often use "recklessness" ambiguously, reckless misrepresentation could be accurately described as a state of mind in which there is an absence of belief in or concern for the reliability of that which is asserted.<sup>175</sup> The SEC may have had such a definition in mind at the outset: in one of its earliest decisions it clearly indicated doubt as to whether evidence of merely "careless misrepresentations" would permit the finding of a violation of one of the statutory provisions upon which the anti-fraud rules were based, but found the evidence adequate

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There the SEC noted that other anti-fraud provisions . . . provide further standards of conduct . . . which of course apply to underwriters." In the latter connection, see also Securities Exchange Act Release No. 6721, at 3-4 (Feb. 2, 1962).

170. Crow, Brouman & Chatkins, Inc., Securities Exchange Act Release No. 7839, at 5 (Mar. 15, 1966) ("diligent inquiry"); Arnold Sec. Corp., Securities Exchange Act Release No. 7813, at 4 (Feb. 7, 1966) ("due diligence and prudence"); Investment Service Co., Securities Exchange Act Release No. 6884, at 7 (Aug. 15, 1962) ("a high degree of care"); Anne Caseley Robin, Investment Advisers Act Release No. 149, at n.2 (Sept. 10, 1963) ("high degree of care"); *Special Study* 375 (duty of "diligent inquiry," citing Investment Service Co., *supra*).

171. Heft, Kahn & Infante, Inc. Securities Act Release No. 7020, at 4 (Feb. 11, 1963); Banner Sec., Inc., Securities Exchange Act Release No. 6985, at 3 (Dec. 28, 1962) ("a reasonable, responsible or careful fulfillment of the duty to deal fairly with investors").

172. See note 82 *supra*.

173. PROSSER, TORTS 715-16 (3d ed. 1964).

174. *Id.* at 716. See also Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 234-41 (1933).

175. Knickerbocker Merchandising Co. v. United States, 13 F.2d 544, 546 (2d Cir. 1926); PROSSER, *op. cit.* *supra* note 173, at 715-16.

where the advisor "knew" statements were without factual warrant and "recklessly failed" to ascertain the material facts.<sup>176</sup>

More recently, in such cases as *A. G. Bellin Sec. Corp.*<sup>177</sup> decided in 1959, a somewhat less precise use of "recklessness" appears. There, salesmen employed by a broker-dealer firm recommended the purchase of stock of General Oil and Industries Company, basing their favorable statements upon a brochure prepared by their own firm. The brochure contained optimistic statements about the company's prospects, but did not give, and the individual salesmen who used it did not have, data as to its financial situation. Suspension of the firm's broker-dealer registration was ordered for violation of the "anti-fraud rules." The SEC, in its opinion, summarized the principal defense thus:

Registrant contends that its use of the brochure was proper, because the information in it was obtained from a report on General distributed by Stratford Securities Co. Inc. ("Stratford"), a securities dealer, from conversation with Josephson, who was General's counsel and stated that the information in that report was correct, and from a letter dated June 24, 1958, received from General, and was later confirmed by letters received from General and by a report of registrant's attorney who visited Texas to check on General.<sup>178</sup>

The SEC, rejecting this defense, stated:

It is obvious that registrant's asserted reliance on the Stratford report, Josephson's verification, and the glowing information supplied by General was at least reckless and misplaced, and was not consistent

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176. *Foreman & Co.*, 3 S.E.C. 132 (1938) [finding a violation of § 17(a) of the Securities Act where such "recklessness" was present (at 141-42) but not where there was only "negligence" (at 138)]. It should be noted that while this opinion was principally concerned with whether there was a "wilful" violation (see note 130 *supra*), it does throw some light on earlier SEC opinions as to what is necessary to show the requisite wilfulness. See, e.g., *Berry & Co.*, Securities Exchange Act Release No. 6349, at 4 n.6 (Aug. 17, 1960).

177. Securities Exchange Act Release No. 5966, May 18, 1959. See also, *Shearson, Hammill & Co.*, Securities Exchange Act Release No. 7743, at 21 (Nov. 12, 1965); *Alexander Reid & Co.*, Securities Exchange Act Release No. 6272, at 4 (Feb. 8, 1962); *N. Pinsker & Co.*, Securities Exchange Act Release No. 6401, at 7 (Oct. 21, 1960). Some of these cases also involved alleged violations of the registration provisions (see text accompanying note 156 *supra*). See also *Mac Robbins & Co.*, Securities Exchange Act Release No. 6462, at 6 (Feb. 6, 1961) (citing *Bellin* in finding a violation by salesmen who were not themselves in violation of the registration provisions). With respect to the latter point, see *id.* at 9.

There have also been references to "indifference to truth" and "gross negligence" in connection with a finding of "wilfulness" in regard to the violation. *Investment Service Co.*, Securities Exchange Act Release No. 6884, at 7 (Feb. 7, 1966); *Mac Robbins & Co.*, Securities Exchange Act Release No. 6462, at 8 (Feb. 6, 1961); *Best Sec., Inc.*, Securities Exchange Act Release No. 6282, at 4 (June 3, 1960). See also note 130 *supra*.

178. *A. G. Bellin Sec. Corp.*, Securities Exchange Act Release No. 5966, at 6-7 (May 18, 1959).

with the existence of a responsible relationship between securities dealer and customer.<sup>179</sup>

As was the case with opinions emphasizing "due care,"<sup>180</sup> opinions like *Bellin* state no criteria for determining "recklessness," apart from implying a circumstantial equation of "reckless" and "irresponsible."<sup>181</sup> Certainly, "recklessness" appears to fall somewhat short of requiring a finding of indifference to reliability.

So long as the standards discussed earlier are available to justify findings of fraud, there is little need for reliance upon this approach. Even so, it can serve a useful purpose in situations where a court shows some hesitation in accepting the other fraud theories.<sup>182</sup> Moreover, it may be destined to play a much larger role in controlling advisory conduct in the future, a possibility considered *infra*, in the examination of the proposals for legislation made by the Special Study Report.<sup>183</sup>

#### 6. "Fraud" Because of a "Fiduciary-Like" Relationship

The fiduciary approach received its judicial send-off in the *Arleen Hughes* case.<sup>184</sup> The respondent Mrs. Hughes had numerous clients with whom she had entered into written agreements stating that she was to act as "principal" in transactions she recommended. These agreements contained a schedule of rates and charges to be paid which called for a slightly higher mark-up per transaction (excess of price to customer over price at which the shares were available in the over-the-counter market) than was usual where a dealer sells a security to a customer. She was, of course, registered both as a broker-dealer and an investment adviser. The SEC sought revocation of the broker-dealer registration because of failure to make the disclosures required of a "fiduciary."<sup>185</sup> The Court of Appeals for the Second Circuit, in 1949, in affirming the SEC's action ordering revocation, stated that the record would support a finding of fraud

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179. *Id.* at 7.

180. See note 156 *supra*. Compare Ala. Rule 26 § 10, 1 1967 BLUE SKY L. REP. ¶ 5636.

181. For example, is testimony of those admittedly competent in the field appropriate? See Wade, *The Attorney's Liability for Negligence*, 12 VAND. L. REV. 755, 766 (1959). "Irresponsible" has overtones of Shingle Theory No. 1. See text accompanying note 84 *supra*.

182. See, e.g., the SEC's language in Alexander Reid & Co., Securities Exchange Act Release No. 6727, at 4 (Feb. 8, 1962), concerning the holding adverse to the SEC in *SEC v. Rapp*, 1957-61 CCH FED. SEC. L. REP. ¶ 91,048 (S.D.N.Y. 1961) which was subsequently reversed. *SEC v. Rapp*, 304 F.2d 786 (2d Cir. 1962).

183. See text accompanying note 296 *infra*.

184. *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949); 3 Loss 1500-08.

185. *Hughes v. SEC*, 174 F.2d 969, 971 (D.C. Cir. 1949).

on two grounds. One was common-law fraud based upon the presence of what Mrs. Hughes admitted was a fiduciary relationship.<sup>186</sup> This relationship created a duty of loyalty which was violated when she "acted simultaneously in the dual capacity of investment adviser and broker-dealer" without adequate disclosure.<sup>187</sup> However, the theory upon which the court stated that it was basing its finding was not grounded in common-law principles of fraud and deceit but upon violation of the "anti-fraud provisions," which were designed to apply "specialized and unique legal treatment" to the task of suppressing the "subtle and involved forms" which fraud may take in this area.<sup>188</sup> Violation resulted from her failure to disclose to her clients the best price at which the securities sold to clients could have been bought in the open market, and the price which she had actually paid for those she had sold to them. The court succinctly stated its reasoning in these terms:

These quoted words ["any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,"] as they appear in the statute can only mean that Congress forbade not only the telling of purposeful falsity but also the telling of half-truths and the failure to tell the "whole truth." These statutory words were obviously designed to protect the investing public as a whole whether the individual investors be suspicious or unsuspecting. The best price currently obtainable in the open market and the cost to the registrant are both material facts within the meaning of the above-quoted language and they are both factors without which informed consent to a fiduciary's acting in a dual and conflicting role is impossible.<sup>189</sup>

Although useful in establishing that persons whom the court termed "admitted fiduciaries" have disclosure obligations imposed by the "anti-fraud" provisions, there is nothing in the opinion to give much help in tagging as a "fiduciary" a person who claims he is not.

There are, to be certain, many situations where application of typical common-law principles would result in finding a fiduciary relationship which results in the imposition of duties of care, skill, and loyalty.<sup>190</sup> But the spectrum of relationships in investment advice fans out from this conventional fiduciary relationship to the situa-

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186. *Id.* at 975. See also *id.* at 976.

187. *Id.* at 975.

188. *Ibid.*

189. *Id.* at 976.

190. See, e.g., *Ramey Kelly Corp.*, Securities Exchange Act Release No. 6209 (March 17, 1960). See also *Special Study* 252-53; BOGERT, *TRUSTS & TRUSTEES* §§ 481 & 541 (2d ed. 1960); 3 *Loss* 1505-08.

tion in which, at some stage, there is a "principal-agent" relationship between the parties,<sup>191</sup> then further to the contractual relationship not involving agency (as where impersonal advice is paid for<sup>192</sup> or a principal sale is induced by sales literature),<sup>193</sup> and, ultimately, to the situation where the advice is relied upon without personal or contractual dealings (as where the market letter of Firm X prompts purchase of a recommended stock from Firm Y).<sup>194</sup> Very early in its application of the anti-fraud rules, the SEC, in *William J. Stelmack Corp.*,<sup>195</sup> suggested that each of these, except perhaps the last, involves a relationship of "special trust and confidence, approaching and perhaps even equaling that of a fiduciary."<sup>196</sup> Emphasizing the *reliance* aspect, the Special Study stated: "Where the relationship between the customer and broker is such that the former relies in whole or in part on the advice and recommendations of the latter, the salesman is, in effect, an investment adviser, and some of the aspects of a fiduciary relationship arise between the two parties."<sup>197</sup>

Despite this broad language, it should be noted that, in contrast to the SEC's approach under the other fraud theories, where it has gone pretty far in the use of "fraud" to develop broad standards of care and skill, the fiduciary theory has not been pushed toward its outer limits.<sup>198</sup> The common law, in dealing with numerous fiduciary relationships, imposes upon fiduciaries not only obligations of loyalty, but also obligations of care and skill.<sup>199</sup> So far the SEC has not generally urged that the designation as a "fiduciary," which results from the duties of loyalty arising out of the "anti-fraud" provisions, also entails the imposition, *in pari passu*, of the fiduciary's required standard of skill.<sup>200</sup> Although the SEC spoke in *Arleen*

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191. For instance, where a market letter sent to a potential customer induces a purchase from the distributing firm which acts as agent. Most firms distribute these at least weekly with this objective in mind. *Special Study* 344-45. See also note 7 *supra*.

192. For instance, where a subscription publication charges for its advice. *Special Study* 359-60.

193. For instance, where a dealer with an inventory sends a market letter to a potential customer which induces a sale by the dealer, as principal, to the recipient. *Special Study* 348-50.

194. See, e.g., *Special Study* 341-42 (describing use of reprints of an advisory publication prepared by the analyst of a firm with a position in the stock).

195. 11 S.E.C. 601 (1942).

196. *William J. Stelmack Corp.*, 11 S.E.C. 601 (1942); *Lawrence R. Leeby*, 13 S.E.C. 499, 505 (1943).

197. *Special Study* 252-53.

198. See text accompanying notes 119 & 156 *supra*. See also Cohen & Rabin 703-04; Loomis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214 (1959).

199. See RESTATEMENT (SECOND), AGENCY § 379 (1958); note 190 *supra*.

200. A fiduciary-like relationship was not emphasized in the numerous opinions cited in the discussion of the other fraud theories. But see *Ramey Kelly Corp.*, Secu-

*Hughes* of the duty of "reasonable diligence" as "a corollary of the fiduciary duty of loyalty,"<sup>201</sup> and, recently, of the "high degree of care" required of one offering investment advisory services,<sup>202</sup> the fiduciary notion has been principally used where the conduct complained of was thought to violate the fiduciary's duty of *loyalty*,<sup>203</sup> as, for instance, the "churning" of discretionary accounts<sup>204</sup> in a "scalping" operation where the adviser trades against the recommendations he gives<sup>205</sup> or use by access persons of "inside information."<sup>206</sup> The use of such an approach in these cases, moreover, can be justified on conventional fiduciary or "trust and confidence" grounds.<sup>207</sup>

Perhaps jurisdictional considerations have played a role in the decision not to emphasize the fiduciary notion in the development of general standards of investment advice. At common law, the fiduciary's violation of his duty of care and skill ordinarily does not constitute "fraud,"<sup>208</sup> while, of course, "disloyalty" does. As a consequence, if the SEC's jurisdiction is limited by notions of "fraud,"<sup>209</sup> however watered-down, then the fiduciary approach leaves vitally important aspects of the fiduciary's activities beyond its reach—unless by some bootstrap magic the duty of loyalty drags both care and skill with it.

Two recent comments from high places add to the piquancy of this line of cases. The United States Supreme Court seems to have gone out of its way, in the recent *Capital Gains Research* decision, to note that fiduciary obligations have implications outside the concept of loyalty.<sup>210</sup> And the present chairman of the SEC has stated<sup>211</sup>

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urities Exchange Act Release No. 6209 (March 17, 1960); *Looper & Co.*, Securities Exchange Act Release No. 5676 (April 15, 1959).

201. 27 S.E.C. 629, 638 (1948).

202. *Paul K. Peers, Inc.*, Investment Advisers Act Release No. 187, at 3 (March 22, 1965). See also *Spear & Staff, Inc.*, Investment Advisers Act Release No. 188, at 5 (March 25, 1965) (where, in the discussion of the duties of "fiduciaries" who advertise their services, the SEC cites opinions not involving registered investment advisers); notes 152 & 170 *supra*.

203. See generally *BAKER & CARY, CORPORATIONS* 416-91 (3d ed. 1959).

204. *Looper & Co.*, 38 S.E.C. 294, 300-01 (1958); *R. H. Johnson & Co.*, 36 S.E.C. 467 (1955), *aff'd*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956); *Norris & Hirschberg, Inc.*, 21 S.E.C. 865 (1946), *petition for rehearing denied*, 22 S.E.C. 558 (1946), *remanded*, 163 F.2d 689 (D.C. Cir. 1947), *cert. denied*, 333 U.S. 867 (1948), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949).

205. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

206. *SEC v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y. 1966); *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

207. See note 255 *infra*.

208. See note 199 *supra*.

209. See text accompanying note 102 *supra*.

210. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963).

211. *Cohen & Rabin* 703-04.

that this fiduciary approach and the fraud theories discussed earlier are, after all, pretty much the same thing and "can be viewed as different ways of characterizing the obligations imposed . . . by the statutory provisions in varying contexts."<sup>212</sup> Together, he suggests, they afford a desirable basis for developing needed standards in this area.<sup>213</sup>

### 7. General Conclusions

How does this melange of theories affect investment advice? The Special Study found no evidence, as the summary given at the outset suggests, that they have had any appreciable impact upon the general run of advisory conduct. Several possible explanations for this can be suggested. The opinions in which the theories are to be found usually involve the vague application of several theories to the same conduct, making a concise and meaningful summary difficult.<sup>214</sup> In fact, such a summary is not to be found.<sup>215</sup> Moreover, these theories, despite the considerable volume of decisions, have, for the most part, been brought to bear upon that very limited segment of the advisory community engaged in what has apparently been considered especially reprehensible conduct.<sup>216</sup> (It is hardly likely, of course, that the SEC or anyone else would suggest that these standards of advisory conduct apply only to this group.) Adding to the confusion is the marked tendency, considered more fully at a later point, to fragmentize the advisory process for purposes of imposing controls.<sup>217</sup>

### 8. Private Actions

Before leaving this subject of federally-created standards for investment advice, there should be some mention of the cases in which a *private action* was based upon the federal statutory provisions. At the outset, we may put to the side cases in this category involving "corporate insiders," and related situations,<sup>218</sup> where an advantage is obtained in a purchase or sale by not disclosing relevant "inside information." Because these cases build upon more conventional

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212. *Id.* at 702-04.

213. *Id.* at 702-08.

214. See note 82 *supra*.

215. 3 Loss 1474-93; Fishman, *Stock Brokers and the Public Investor*, 53 ILL. B.J. 992 (1965); Ruder, *Negligent Misrepresentation Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965); *Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658 (1965). See also Levin & Evan, *Professionalism and the Stockbroker*, 21 BUS. LAW. 337 (1966).

216. See note 72 *supra*. A recent and significant exception is Shearson, Hammill & Co., Securities Exchange Act Release No. 7743 (Nov. 12, 1965).

217. See text accompanying notes 271 & 296 *infra*.

218. See BAKER & CARY, CORPORATIONS 536-52 (3d ed. 1959). See also note 206 *supra*.



fraud notions,<sup>219</sup> they throw little light on the application of the "anti-fraud" concepts to typical advisory activity.

Recognition of a private cause of action was not achieved without birth pangs. The courts first grappled with the problem of the *seller* who wanted to bring a private action complaining of fraud, and sought to base his cause on the federal statutes.<sup>220</sup> While sections 11 and 12 of the 1933 act expressly provided—in some situations at least—for private actions *against* the seller, there was no comparable express provision in either of the acts for one *by* him.<sup>221</sup> A way around this was found, but over some rocky ground. A cause was created by implication from the fact that other sections (particularly 10(b)(5))<sup>222</sup> made fraudulent conduct unlawful. Moreover, having recognized a right by implication in favor of the seller, the buyer, also, was found to have a cause of action on the same theory, despite his express rights under sections 11 and 12. To reach this conclusion, however, the courts felt compelled to differentiate between the express private action and that which was implied, because the sections expressly creating the right, in addition to imposing other important limitations upon that right, also created a defense for the seller: in the exercise of reasonable care, the defendant could not have discovered the truth.<sup>223</sup> This language is not to be found in the sections on which the implied cause is based. "Scienter" was the equalizer—it was held not necessary to the expressly created action because the "reasonable care" defense provided a substitute; however, a finding of its presence was held obligatory in actions which arose by implication. The leading case is an opinion in the Second Circuit, *Fischman v. Raytheon Mfg. Co.*,<sup>224</sup> in which Judge Jerome Frank wrote for the court.

That there is much about this which is puzzling has been commented upon by scholars.<sup>225</sup> However this may be, the position taken in *Fischman* that the private cause of action on the implied theory requires an allegation of "scienter," albeit a watered-down version,<sup>226</sup>

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219. See note 255 *infra*.

220. See generally 3 Loss 1778-92.

221. Securities Act §§ 11 & 12(2).

222. Securities Act § 17a; Exchange Act § 10b. Both sections are referred to in *Fischman v. Raytheon Mfg. Co.* (discussed at note 224 *infra*), but principal reliance is rested upon 10b. See also Ruder *supra* note 215; *Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658 (1965).

223. See note 164 *supra*.

224. 188 F.2d 783, 787 (2d Cir. 1951); 3 Loss 1778-92.

225. See *ibid*; Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 NW. U.L. REV. 185 (1964). See also Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933).

226. See text accompanying note 174 *supra* and authorities cited in note 214 *supra*.

while the expressly created cause does not, seems to have taken hold in a substantial number of courts,<sup>227</sup> even though some disagree.<sup>228</sup>

When Judge Frank's conclusions, and the SEC's approach are compared,<sup>229</sup> it is obvious that we are faced with differing notions of "fraud." According to the former, a private action under sections 10(b) and 17(a) requires proof of scienter. On the other hand, the SEC's anti-fraud theories, discussed at length above, are based upon the same sections,<sup>230</sup> and the SEC does not treat scienter as necessary. While it seems clear that an action brought by the SEC complaining of fraudulent conduct need not allege all the elements necessary to make out a private cause based upon the same facts, particularly with respect to reliance and proof of loss,<sup>231</sup> surely the basic characteristics of the outlawed conduct should be the same.

Perhaps in part because of the uncertainty which these cases reflect as to what will support a cause of action for improper advisory conduct, the private suit has not played an important role in controlling such conduct. The reported decisions have not complained of the care and skill aspects of advisory conduct by professionals.<sup>232</sup>

### C. Controls at the State Level

If blue sky laws, the repository of state statutory controls in this area, are effective in policing advisory conduct, there is little sign of it in the reported decisions and administrative orders or in the conduct of those in the business.<sup>233</sup> All states but one have blue sky laws,<sup>234</sup> and over half the states require securities salesmen to pass an examination of some sort.<sup>235</sup> While some unqualified people have undoubtedly thereby been excluded from the business, these examinations, like those required by the self-regulatory organizations,

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227. *Glickman v. Schweickart*, 242 F. Supp. 670 (S.D.N.Y. 1965); *Weber v. C.M.P. Corp.*, 242 F. Supp. 321 (S.D.N.Y. 1965); *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965); *Miller v. Bargain City U.S.A.*, 229 F. Supp. 33 (E.D. Pa. 1964); *Trussel v. United Underwriters, Ltd.*, 228 F. Supp. 757 (D. Colo. 1964).

228. *Kohler v. Kohler*, 319 F.2d 634 (7th Cir. 1963); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961); *Dack v. Sharman*, 227 F. Supp. 26 (S.D.N.Y. 1964); *Texas Continental Life Ins. Co. v. Bankers Bond Co.*, 187 F. Supp. 14 (W.D. Ky. 1960).

229. Compare text accompanying notes 153 & 170 *supra*.

230. See text accompanying note 76 *supra*.

231. See 3 *Loss* 1757-92.

232. See cases cited in notes 227 & 228 *supra*. But see *Bercow v. Kidder, Peabody & Co.*, 1964-66 CCH FED. SEC. L. REP. ¶ 91,452 (S.D.N.Y. 1964).

233. See *Loss & Cowett*, *BLUE SKY LAW* 86 (1958); *Special Study* 148-49, 322-23, 374.

234. *Loss & Cowett*, *supra* note 233, at 17; 1 1967 *BLUE SKY L. REP.* ¶ 503. The exception is Nevada.

235. *Special Study* 133.

make no real effort to test competence in securities research and analysis.<sup>236</sup>

Most of the state statutes proscribe "fraud,"<sup>237</sup> but there is considerable variety of approach in defining it: several clearly cover at least some forms of negligent conduct,<sup>238</sup> while others, patterned on the federal statute, possibly encompass such conduct.<sup>239</sup> Some contain stringent scienter requirements.<sup>240</sup> A number expressly provide the investor with a private remedy having varying limitations.<sup>241</sup>

Although these statutes have not given rise to administrative rules comparable in extent to those created at the federal level, regulations of some interest are to be found in several states. In some, specific investment advice practices are prohibited, such as use of "comparisons"<sup>242</sup> and assurances that an investment is "safe."<sup>243</sup> In others, there are echoes of the "shingle" theory in prohibitions against both "excessive mark-ups"<sup>244</sup> and violations of the "suitability" principle.<sup>245</sup> Concern for "loyalty" is also apparent in the prohibition of such specific conduct as failure to reveal an interest in a recommended security,<sup>246</sup> trading "against orders,"<sup>247</sup> and "churning."<sup>248</sup> One state, Alabama, specifically provides that a

236. See *Special Study* 125, 129, 131-33, 145-46, 374; LOSS & COWETT, *supra* note 233, at 252-56. See also *Hearings on H.R. 6789, H.R. 6793 and S. 1642 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 88th Cong., 1st Sess., pts. 1 & 2, at 143, 144, 147 (1964).

237. 1 1967 BLUE SKY L. REP. ¶ 503; LOSS & COWETT, *supra* note 233, at 21. A number, of course, carry criminal sanctions. *Id.* at 21-25, 387-89.

238. ALA. CODE tit. 53, § 45(a)(2) (1958); ALA. Rule 7B, 1 1967 BLUE SKY L. REP. ¶ 5617; IND. ANN. STAT. § 25-854 (repl. vol. 1960); ORE. REV. STAT. § 59.260 (1966).

239. See LOSS & COWETT, *supra* note 233, at 147-60. See also *Special Study* 374 n.277, 322-23.

240. PA. STAT. ANN. tit. 70, §§ 32(i), 45 (1965).

241. LOSS & COWETT, *supra* note 233, at 147.

242. ALA. Rule 19 § 9, 1 1967 BLUE SKY L. REP. ¶ 5629; CAL. ADMIN. CODE tit. 10, § 649 (1945); ARIZ. Order S-2, 1 1967 BLUE SKY L. REP. ¶ 6652.

243. ALA. Rule 19 § 13, 1 1967 BLUE SKY L. REP. ¶ 5629; ARIZ. Order S-2, 1 1967 BLUE SKY L. REP. ¶ 6652.

244. 2 1967 BLUE SKY L. REP. (Mich.) ¶ 25,672; N.D. CENT. CODE § 10-04-11(4) (1960); OHIO REV. CODE ANN. § 1707.19 (Page 1964); Ohio Ruling 28, 2 1967 BLUE SKY L. REP. ¶ 38,728; TENN. CODE ANN. § 48-1629 (repl. vol. 1964); see text accompanying note 87 *supra*.

245. ALA. Rule 26 § 13, 1 1967 BLUE SKY L. REP. ¶ 5636; Mich. Rule 110, 2 1967 BLUE SKY L. REP. ¶ 25,660.

246. ALA. Rule 19 § 110, 1 1967 BLUE SKY L. REP. ¶ 5629; CAL. ADMIN. CODE § 651 (1963); OHIO D.S.-8, 2 1967 BLUE SKY L. REP. ¶ 38,668.

247. ALA. Rule 26 § 7, 1 1967 BLUE SKY L. REP. ¶ 5636; N.Y. PEN. LAW § 952 (McKinney 1944).

248. ILL. Rule 190, 1 1967 BLUE SKY L. REP. ¶ 16,635; Mich. Rule 110, 2 1967 BLUE SKY L. REP. ¶ 25,660; Wis. § 1.05, 3 1967 BLUE SKY L. REP. ¶ 52,605; Wis. § 1.15, 3 1967 BLUE SKY L. REP. ¶ 52,615.

broker-dealer shall be subject to "fiduciary obligations" in dealing with his clients.<sup>249</sup>

Despite what appears to be a pattern of expanding state regulation, there is, under these statutes, a dearth of case law development involving care and skill in advisory conduct.<sup>250</sup> There are, however, recent indications of greater judicial activity in this area.<sup>251</sup> Much the same picture appears when the cases relying upon common-law principles are examined. The successful use of "fraud" as including lack of care and skill in the advisory process has not been extensive,<sup>252</sup> despite the willingness of some state courts to absorb the law of negligence into the law of fraud.<sup>253</sup> On the other hand, there are several actions based upon conventional negligence in which both the diligence and skill of the investment advisor are given consideration.<sup>254</sup> More frequent are cases in which equitable relief is awarded upon proof of a conventional fiduciary or "trust and confidence" relationship and a violation of the duty of loyalty inherent in it.<sup>255</sup>

In all, there seems to be little reason to question the conclusion of those who assert that state controls and sanctions are of little consequence in policing advisory conduct.<sup>256</sup>

## V. DEVELOPMENTS SINCE THE SPECIAL STUDY

Although the Special Study does not contain a critical examination of the fraud theories,<sup>257</sup> it does, if nothing else, raise serious questions as to the adequacy of the SEC's fraud approach, and thus casts doubt on the only viable means presently available to encourage care and skill in the more important aspects of advisory conduct.<sup>258</sup>

249. Ala. Rule 26 § 10, 1 1967 BLUE SKY L. REP. ¶ 5636.

250. 1 1967 BLUE SKY L. REP. ¶¶ 3955, 3571. See also authorities cited in note 215 *supra*.

251. *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757, 762 (D. Colo. 1964). The *Special Study* found an increasing interest on the part of the states in competency standards in this area. *Special Study* 133.

252. An extensive search reveals several cases where this was attempted, *e.g.*, *Weber v. C.M.P. Corp.*, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,539 S.D.N.Y. 1965); *Bercow v. Kidder, Peabody & Co.*, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,452 (S.D.N.Y. 1964); *Otis & Co. v. Grimes*, 97 Colo. 219, 48 P.2d 788 (1935); *S. Curtiss & Co. v. White*, 90 S.W.2d 1095 (Tex. 1935).

253. See text accompanying note 109 *supra*.

254. *E.g.*, *Twachtman v. Connelly*, 106 F.2d 501 (6th Cir. 1939); *Warwick v. Addicks*, 35 Del. 43, 157 Atl. 205 (Del. 1931); *Lieberman v. McDonnell*, 97 Cal. App. 171, 275 Pac. 486 (1929).

255. Compare *Fischer v. Slayton Co.*, 10 Ill. App. 2d 167, 134 N.E.2d 673 (1956) with *O'Connor v. Burns, Potter & Co.*, 151 Neb. 9, 36 N.W.2d 507 (1949).

256. See note 233 *supra*.

257. They are given brief mention in *Special Study* 139, 145-48, 302, 375.

258. See text accompanying notes 53 & 233 *supra*.

These doubts are raised only by implication, however, for rather than examining the fundamental soundness of the fraud approach, the Special Study seems to have assumed that this way of dealing with problems of investment advice is basically sound, and only in need of being strengthened and supplemented.<sup>259</sup> Proposals to this end, following three general lines, can be found among the Study recommendations.<sup>260</sup>

The first approach includes proposals that the self-regulatory organizations adopt rules or policy statements which would deter firms from representing in advertising materials, as they habitually have done,<sup>261</sup> that they offer research and advisory services when they are not reasonably equipped to do so,<sup>262</sup> and that firms be required to disclose, in printed advisory materials, the sources of information relied on and the research techniques used.<sup>263</sup> Less was to be required in the case of oral advice, since it was apparently considered to be fundamentally different: there should be "disclaimers" when advice does not emanate from the firm's own research department, and the prediction of future specific price levels of individual stocks is to be condemned.<sup>264</sup> These are, in the main, disclosure proposals, designed to give the investor some warning as to what he is getting rather than attempting to establish standards of skill and care for advisory conduct generally.<sup>265</sup>

In discussions before congressional committees considering the Special Study recommendations, the SEC took the position that these proposals could be implemented under its existing authority to control "fraud."<sup>266</sup> The proposals have not, however, brought about any change in the SEC's rules.<sup>267</sup> The response has been more positive elsewhere, for the recommendations seem to have prompted

259. *Special Study* 237-42, 302-04, 328-30, 375-76, 383-87. See also *id.* at 5-6.

260. These are to be found in *Special Study* 386-87. See also *id.* at 158-60.

261. See note 38 *supra*.

262. *Special Study* 386, para. "1." See also note 23 *supra*.

263. *Special Study* 386-87, para. "2." These include disclosure of sources of information, research techniques used or other bases of information; name of person responsible for preparation of the material, and dating of the material; most recently filed disclosures of issuers and representation that such data has been examined (or identification of issuers for which no data is available). Predicting future specific price levels should also be prohibited.

Other practices, such as trading against advice and claiming to have "inside information," which are less closely related to formulation of recommendations, are also criticized. *Id.* at 386-87.

264. *Id.* at 386, para. "2."

265. See text accompanying notes 69 & 105 *supra*.

266. *Hearings on H.R. 6789, H.R. 6793 and S. 1642, supra* note 236, at 29.

267. See 1 CCH FED. SEC. L. REP. ¶ 4800; 2 *id.* at ¶¶ 22,725 & 25,065. See also 2 *id.* at ¶¶ 25,059-25,060 A-D (regulation of broker-dealers not members of a registered national security association: proposed regulation).

changes in the regulations of the New York and American Stock Exchanges and the NASD.<sup>268</sup> The most important, and interesting, of these is a change in their respective "standards for advertising, market letters, sales literature, research reports, radio, television and writing activities," to the effect that printed advisory recommendations "must have a basis which can be substantiated as reasonable,"<sup>269</sup> and the addition of a provision that where a member organization "advertises or promotes its research services or capabilities [it] must have a reasonable basis for any claims it makes."<sup>270</sup>

These rules are disappointing in several respects. They are principally aimed at printed advisory materials, and thus perpetuate the artificial and undesirable distinction between oral and written advice.<sup>271</sup> Furthermore, no "guidelines" are suggested for determining what constitutes a "reasonable basis" in this situation. Without some elaboration, it may be doubted whether this "reasonable basis" rule will have any greater impact upon the bulk of advisory conduct than did the SEC's own "reasonable basis" (Shingle Theory No. 3) rule which was in effect at the time of the Special Study investigation.<sup>272</sup> The manner in which these recommendations were commented upon by the self-regulatory organizations when the recommendations were receiving congressional attention, suggests that they were thought to involve little in the way of change.<sup>273</sup> These developments do, of course, serve to arm the SEC with honest-to-goodness standards of the profession for purposes of Shingle Theory No. 1.<sup>274</sup>

Since the Special Study recommended that comparable substantive rules be adopted with respect to that segment of the investment

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268. See *Hearings on H.R. 6789, H.R. 6793 and S. 1642, supra* note 236, at 145, 240, 1256.

269. CCH AM. STOCK EXCH. GUIDE ¶ 9495 (1964); 2 CCH N.Y. STOCK EXCH. GUIDE ¶ 2474 A.10(1); NATIONAL ASSOCIATION OF SECURITIES DEALERS, NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL G-21 (1965).

270. CCH AM. STOCK EXCH. GUIDE ¶ 9495.10(9) (1964); 2 CCH N.Y. STOCK EXCH. GUIDE ¶ 2474 A.10(9) (1964). See also NATIONAL ASSOCIATION OF SECURITIES DEALERS, *op. cit. supra* note 269, at G-22.

271. From the investors' point of view, it is difficult to appreciate a system of regulation concerned principally with controls for impersonal printed advice rather than for personal oral advice. This, however, appears to be the case. See also *Special Study* at 386-87 (especially paras. "1" & "2"), with which compare 328-30 (especially paras. "4" & "5"); Rule 483, CCH AM. STOCK EXCH. GUIDE ¶ 9493 (1964); NATIONAL ASSOCIATION OF SECURITIES DEALERS, *op. cit. supra* note 269, at G-19 to 22. *But see* ASSOCIATION OF STOCK EXCHANGE FIRMS, MANUAL FOR REGISTERED REPRESENTATIVE 11 (1963) ("the advice given must be based on good faith and upon informed judgment of investment facts, not on rumor"). See text accompanying note 296 *infra*.

272. See text accompanying note 118 *supra*.

273. *Hearings on H.R. 6789, H.R. 6793 and S. 1642, supra* note 236, at 360-61, 394, 410-11, 475-76, 690, 705-07.

274. See text accompanying note 99 *supra*.

advice community which charges for its advice,<sup>275</sup> such rules are presumably being considered by the SEC, along with other questions relating to that group, such as whether it should be organized into an official "self-regulatory organization."<sup>276</sup> It is possible, however, that the SEC may feel that the "anti-fraud rules" are adequate to deal with this segment of the advisory community as well as others not affiliated with a self-regulatory group.<sup>277</sup> This would seem to be indicated by its recently released "proposed rules" for broker-dealers who are not members of a registered self-regulatory organization, which do not include a "reasonable basis" standard.<sup>278</sup>

The second major recommendation appeared in that part of the report concerned with "qualification for entry into the securities business,"<sup>279</sup> a matter given considerable emphasis in the report.<sup>280</sup> The Special Study findings showed that practically anyone could enter and had entered the business of giving securities advice.<sup>281</sup> To remedy this, the report stated that standards for entry should generally encompass "(a) competence, in the sense of knowledge and experience, (b) character and integrity, and (c) financial capacity and responsibility."<sup>282</sup> With particular reference to advisory activities, the Special Study recommended that experience qualifications should in all cases be required "for the supervisor of research activities."<sup>283</sup>

In its legislative proposals to implement the report recommendations, the SEC successfully sought authority to put entry standards into effect.<sup>284</sup> The 1964 amendments granted the SEC the power to require self-regulatory agencies to adopt standards which are necessary or desirable with respect to "training, experience, and . . . other qualifications";<sup>285</sup> where there is no appropriate self-regulatory organization to impose such standards, the SEC may do so.<sup>286</sup> This legislation, which applies only to broker-dealers and their em-

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275. *Special Study* 386, para. "5."

276. *Ibid.* See also *id.* at 148.

277. See in this connection, *Special Study* 382-83. Compare *id.* at 375-76. The *Special Study* report shows ample reason for concern for advisory conduct by this group. *Special Study* 334-44, 363-69; *Hearings on H.R. 6789, H.R. 6793 and S. 1642, supra* note 236, at 5, 155.

278. CCH FED. SEC. L. REP. ¶ 77,412 (1966).

279. *Special Study* 47-162.

280. *Ibid.* See also *Hearings on H.R. 6789, H.R. 6793 and S. 1642, supra* note 236, at 71, 103-05, 111, 125-26.

281. See note 65 *supra*.

282. *Special Study* 160, para. "6."

283. *Id.* at 161, para. "8."

284. *Hearings on H.R. 6789, H.R. 6793 and S. 1642, supra* note 236, at 50, 103-05; see note 280 *supra*.

285. Exchange Act § 15(A)(b)(5), 2 CCH FED. SEC. L. REP. ¶ 20,380 (1964).

286. Exchange Act § 15(b)(8), 2 CCH FED. SEC. L. REP. ¶ 20,360 (1964).

ployees,<sup>287</sup> has brought about two developments. First, the SEC has adopted a rule to cover broker-dealers who are not members of a self-regulatory organization which requires an examination, "if any part of their securities activities is in . . . research or investment advice."<sup>288</sup> Successful completion of several examinations currently required of salesmen, including those required by twenty-one states, will fulfill the SEC requirement.<sup>289</sup> Second, the New York and American Stock Exchanges have amended their rules to require that printed advisory material reaching the public must be approved by a "supervisory analyst acceptable to the Exchange."<sup>290</sup>

When examined in light of the emphasis given this matter by the Special Study recommendations, these steps appear quite modest.<sup>291</sup> Here, too, an investor may be puzzled by the preoccupation of the exchange with standards for written advice,<sup>292</sup> particularly in view of the Study's conclusion that "minimal standards of competence or experience should be applied to each person who is responsible for actually transmitting unsupervised investment recommendations to the public."<sup>293</sup> Of course, entry standards related to competence in both formulating and communicating investment advice, such as those suggested for the "supervisory analyst," will undoubtedly contribute to an aura of "professionalism"<sup>294</sup> in this area of business activity. Yet it should be emphasized that such entry standards do not remedy the weaknesses which have been explored in the cases resting on the fraud approach: once entry standards are met, the SEC must still fall back on those fraud theories to police advisory

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287. *Ibid.* The recommendations clearly indicate that comparable developments are necessary in the case of registered investment advisers. See notes 13 & 276 *supra*.

288. Exchange Act Reg. 240.15b8-1, 2 CCH FED. SEC. L. REP. ¶ 26,904 (1967).

289. Securities Exchange Act Release No. 7697, Sept. 7, 1965. See also Securities Exchange Act Release No. 7603, May 18, 1965.

290. Rule 483, *supra* note 271; Rule 472, 2 CCH N.Y. STOCK EXCH. GUIDE ¶ 2472 (1964); Rule 344, 2 CCH N.Y. STOCK EXCH. GUIDE ¶ 2344 (1964); Rule 343, CCH AM. STOCK EXCH. GUIDE ¶ 9343 (1964). See also NATIONAL ASSOCIATION OF SECURITIES DEALERS, *op. cit. supra* note 269, at G-22. There are, of course, private organizations with impressive standards in the advice area, such as the "Financial Analysts Federation." *Hearings on H.R. 6789, H.R. 6793 and S. 1642, Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 88th Cong., 1st Sess., pts. 1 & 2, at 150. See also *id.* at 361.

291. Although great emphasis is placed upon the individual (see *Special Study* 160 para. "4") as the proper "unit" for regulation purposes (see also *id.* at 250, 323-24), the principal concern here seems to be the qualification of supervisory personnel in distributing printed advisory material. This leaves to some other, not so obvious, control approach the oral investment advice originating with the salesman, as well as that coming over the firm's wire service. See *Special Study* 358; text accompanying note 4 *supra*.

292. See notes 271 *supra* and 296 *infra*.

293. *Special Study* 158.

294. See text accompanying note 70 *supra*.



conduct.<sup>295</sup> Little help can be expected from the self-regulatory agencies in this regard, since little has been done to put teeth into their policing of standards of care and skill.

Finally, a third general recommendation of the Study report urged the adoption of legislation or rules which would both expressly prohibit "reckless dissemination of written investment advice" and, where it occurs, subject those responsible "to civil liability in favor of customers reasonably relying thereon to their detriment."<sup>296</sup> Once again the emphasis is upon *written* advice. Implementing legislation was not sought by the SEC,<sup>297</sup> and the House subcommittee during its hearings asked for an explanation.<sup>298</sup> Acknowledging that the proposals "would prohibit reckless dissemination of written investment advice,"<sup>299</sup> Chairman Cary admitted that the SEC was "in agreement with" the recommendations,<sup>300</sup> but gave no indication as to how they might be put into effect.<sup>301</sup> This indication of agreement is incomprehensible unless the SEC is thinking of retreating from the position taken under the several anti-fraud theories, where the SEC has not insisted upon a finding of "recklessness," and where coverage has not been limited to written advice.<sup>302</sup> There would, of course, be some merit in putting the private right on a less attenuated basis.<sup>303</sup>

## VI. CONCLUSION

The Special Study findings show a pressing need for a re-examination of the controls over investment advice. First, most of those giving advice have acted as if there were no controls, and have professed to know of no minimum required standard of skill in the task of formulating investment recommendations. This is, perhaps, understandable in view of the subtleties of the fraud approach and the vagueness of its impact on investment advice. Second, while the historian might be able to explain the differing treatment of written

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295. PROSSER, TORTS 167-68 (3d ed. 1964).

296. *Special Study* 387, para. "4."

297. *Hearings on H.R. 6789, H.R. 6793 and S. 1642, supra* note 290, at 29.

298. *Id.* at 28.

299. *Ibid.*

300. *Ibid.*

301. *Ibid.*

302. See text accompanying notes 152, 170 & 172 *supra*. It has indicated elsewhere that it thinks this might be handled by a rule. *Hearings on H.R. 6789, H.R. 6793 and S. 1642, supra* note 290, at 483; SEC Special Market Study Release No. 25, at 5, April 30, 1963.

303. See text accompanying note 229 *supra*. Here, too, there is a serious definitional problem. *Hearings on H.R. 6789, H.R. 6793 and S. 1642, supra* note 290, at 708, 821. See also note 181 *supra*.

and oral advice, no one could convince an investor that this should be so.

Clearly some valuable additions to advisory conduct controls are traceable to the Special Study. Where there had been few entry standards, now there are more, albeit modest and applicable only to broker-dealers. Also, as regards broker-dealers, there is now a requirement that printed materials be approved by a "supervisory analyst." But in the all-important area of general standards little has changed. The SEC seems satisfied with the complicated line of argument it has successfully used, presumably because this line has been good enough to win. Yet, these fine-spun fraud theories obviously are unintelligible as behavior standards. As a result, most firms have conceived of their advisory task as involving merely the duty to give an honest opinion about a stock, based upon a rapid check of readily available material. It would be surprising if they view their duty any differently since the Special Study, although some firms may feel greater restraint in using their "research" label. Moreover, it might be argued that the anti-fraud rules, despite the extension of their tentacles, have application only to extremely reprehensible advisory conduct, and really do not reach the run-of-the-mill variety.<sup>304</sup> Assuming this to be so, and assuming also that there are some unexpressed, self-imposed limitations upon the SEC in its application of these rules, the need for standards becomes all the more imperative and the confusion over the "fraud rules" even greater.

Before the factual findings of the Special Study grow useless with age, there should be a clearer delineation of standards by both the SEC and the self-regulatory organizations. The standards adopted should not treat oral and printed advice as if they were functionally different, one from the other; rather, identical, clearly defined standards of care and skill should be applied to all advisory activity which must have a sound, professional research base if it is responsibly prepared.<sup>305</sup> Such an approach need not rule out recognition of a category of "merchandising" firms, rather than "advisory" firms, which, perhaps, could be permitted to disseminate purely "factual information," clearly identified as such. With a clearer delineation of standards, the SEC and the self-regulatory agencies could concentrate their enforcement efforts upon broader problems, such as the

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304. Levin and Evan, *Professionalism and the Stock Broker*, 21 BUS. LAW. 337 (1966). See also *Special Study* 326-27.

305. See, with respect to general standards, the testimony of Amyas Ames, President, American Bankers Association of America, *Hearings on H.R. 6789, H.R. 6793 and S. 1642*, *supra* note 290, at 686, 707, & 731. See also note 306 *infra*.

conspicuous absence of both adequate numbers of personnel qualified to carry on "advisory activities," and procedures to assure the utilization of their services. Also, with a clarification of responsibilities, the private action could be expected to play a more important enforcement role.

As was truly stated by Mr. Amyas Ames, President of the Investment Bankers Association of America, in his testimony before the House subcommittee during hearings on the Special Study recommendations:

Many, if not most, of the abuses and undesirable practices described in the [Special Study] report could be eliminated to a very great extent by the imposition and enforcement of higher standards of conduct, experience, competency, integrity, and financial responsibility which must be met by persons engaged in the securities business.<sup>306</sup>

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306. *Hearings on H.R. 6789, H.R. 6793 and S. 1642, supra* note 290, at 676. It is apparent that Mr. Ames favored general standards, rather than an elaborate web of controls, for those in different segments of the industry doing essentially the same task. See note 305 *supra*.