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Securities-Investment Advisers Act of 1940-Antifraud Provisions Interpreted

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SECURITIES—INVESTMENT ADVISERS ACT OF 1940—ANTIFRAUD PROVISIONS INTERPRETED—Defendant, Capital Gains Research Bureau, Inc., an investment advisory service, published a bulletin entitled "A Capital Gains Report," each issue of which advised approximately 5,000 subscribers as to the investment potential of a particular corporation's stock. On at least five occasions Capital Gains, and its president and sole stockholder, also a defendant, acquired some shares of a stock and, without revealing their interest therein, recommended its purchase in the bulletin. Following each recommendation, trading in the stock increased, the price rose, and, within a few days, defendants sold their shares at a profit.[1] The Securities and Exchange Commission, alleging that defendants, by failing to disclose their individual interests in the stocks, had violated section 206, clauses (1) and (2), of the Investment Advisers Act of 1940,[2] sought a temporary restraining order, preliminary injunction, and final injunction against defendants. Clauses (1) and (2) provide: "It shall be unlawful for any investment adviser . . . (1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business, which operates as a fraud or deceit upon any client or prospective client." The district court denied the motion for a preliminary injunction.[3] A three-judge panel of the Court of Appeals for the Second Circuit affirmed, one judge dissenting.[4] Upon rehearing en banc, *held*, affirmed, four judges dissenting. Under clauses (1) and (2), an investment adviser is under no affirmative duty to those advised to disclose information regarding his personal holdings in a recommended stock. *SEC v. Capital Gains Research Bureau, Inc.*, 306 F.2d 606 (2d Cir. 1962), *cert. granted*, 371 U.S. 967 (1963).

At common law, where one party to a business transaction is under a duty of disclosure, he is liable to the other for harm caused by his intentional failure to disclose facts of which the other is ignorant and which

1 On a sixth occasion, defendants took a short position in a stock and, without disclosing this position, advised that the stock was overvalued. Immediately following this advice, trading in the stock increased, the price fell, and defendants bought in at a profit.

2 54 Stat. 852, 15 U.S.C. §§ 80b-6(1), (2) (1958). For general surveys of the act, see 2 LOSS, SECURITIES REGULATION 1392-1417 (2d ed. 1961); 3 *id.* at 1515-18; Reese, *Securities Legislation of 1960*, 17 BUS. LAW. 412 (1962).

3 SEC v. Capital Gains Research Bureau, Inc., 191 F. Supp. 897 (S.D.N.Y. 1961).

4 SEC v. Capital Gains Research Bureau, Inc., 300 F.2d 745 (2d Cir. 1961).

he would regard as material in determining his course of action.[5] The early development of this form of the law of deceit occurred in the context of the traditional fiduciary or confidential relationships involving, for example, agents and trustees.[6] The extent to which Congress, in enacting clauses (1) and (2), intended to apply them to the comparatively modern investment adviser-client relationship, and to liberalize the common-law requirements of the tort in recognition of the special needs of the securities business, presented the pivotal issue in the principal case.

In response to this issue, the district court ruled that the concepts of fraud and deceit in clauses (1) and (2) were employed by Congress in the strict common-law sense, that in order to sustain a violation it is necessary to prove that defendants' conduct resulted in loss to clients or prospective clients, and that no such showing had been made.[7] This interpretation seems unduly restrictive. In construing various antifraud provisions of the federal securities laws, in particular section 17(a) of the Securities Act of 1933,[8] upon which clauses (1) and (2) were based,[9] the courts have frequently declared that in order to sustain a violation every element of common-law deceit need not be proved;[10] in particular, proof of loss has been deemed unnecessary.[11] This liberalization is the result of a recognition by Congress and the courts of the unique nature of the securities business.[12] "The essential objective of securities legislation is to protect

5 PROSSER, TORTS § 87 (2d ed. 1955); RESTATEMENT, TORTS § 551 (1938).

6 2 RESTATEMENT (SECOND), AGENCY § 389 (1958); 1 RESTATEMENT (SECOND), TRUSTS § 170 (1959).

7 Alternatively, the court said that proof that defendants intended their clients or prospective clients to suffer a loss would satisfy clauses (1) and (2). Yet, not even at common law was such an intent an element of the tort of deceit. 1 HARPER & JAMES, TORTS § 7.3 (1956); PROSSER, *op. cit. supra* note 5, § 88.

8 48 Stat. 84, as amended, 15 U.S.C. § 77q(a) (1958).

9 *Hearings on S. 1178 to S. 1182 Before the Subcommittee on Securities of the Senate Banking and Currency Committee*, 86th Cong., 1st Sess. 516-17 (1959); 3 Loss, *op. cit. supra* note 2, at 1515. Clauses (1) and (3) of § 17 provide: "It shall be unlawful for any person in the offer or sale of any securities . . . (1) to employ any device, scheme, or artifice to defraud, or . . . (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." 48 Stat. 84, as amended, 15 U.S.C. § 77q(a) (1958).

10 Norris & Hirshberg, Inc. v. SEC, 177 F.2d 228 (D.C. Cir. 1949); Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949); Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944); Archer v. SEC, 133 F.2d 795 (8th Cir.), *cert. denied*, 319 U.S. 767 (1943). Though such statements have usually been made in regard to deceit by misrepresentation, they would seem to apply with equal force to deceit by nondisclosure.

11 "The fraud known to common law which required reliance on the alleged false statements and resulting damage to the person addressed is not the fraud required to constitute a violation of § 17(a)(1) of the Securities Act of 1933." Los Angeles Trust Deed & Mortgage Exch. v. SEC, 264 F.2d 199, 210 (9th Cir. 1959). Similarly, in Hughes v. SEC, *supra* note 10, at 974, a suit to revoke a broker-dealer's registration for fraudulent activities, the court said that "the revocation is proper even if one, or none, of the particular clients here involved has been misled or has suffered injury."

12 "The business of trading in securities is one in which opportunities for dishonesty are of constant recurrence and ever present. It engages acute, active minds, trained to quick apprehension, decision and action. The Congress has seen fit to

those who do not know market conditions from . . . those who do."[13]

Apparently recognizing the unreasonableness of the requirement of proof of loss under clauses (1) and (2), the majority in the principal case rejected the district court's position. It affirmed, however, the finding that deceit by nondisclosure had not been proved, on the ground that an investment adviser is under no affirmative duty to those advised to reveal information regarding his personal holdings in a recommended stock. This determination was based primarily upon implications drawn from a recent amendment of section 206 and the legislative history preceding that amendment. In 1960, Congress altered section 206 by adding clause (4), which provides: "It shall be unlawful for any investment adviser . . . (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative."[14] In support of the enactment of this provision, the SEC had expressed the doubt that clauses (1) and (2) were limited by common-law concepts of fraud and deceit, and suggested that clause (4) would enable the Commission "to deal adequately with such problems as a material adverse interest in securities which the adviser is recommending to his clients."[15] This purported inadequacy of clauses (1) and (2) induced Congress to enact clause (4).[16] Likewise, it influenced the holding of the majority of the court in the principal case.

It is clear, nevertheless, that the relationship between the adviser and his clients should be one of trust and confidence.[17] Indeed, he has been termed a fiduciary,[18] a characterization which has found some judicial support.[19] Whether he advises individual clients in personal interviews or a large number of persons through the mails, the investment adviser expressly or impliedly represents that he is disinterested and that his paid

regulate this business. Though such regulation must be done in strict subordination to constitutional and lawful safeguards of individual rights, it is to be enforced notwithstanding the frauds to be suppressed may take on more subtle and involved forms than those in which dishonesty manifests itself in cruder and less specialized activities." Archer v. SEC, 133 F.2d 795, 803 (8th Cir. 1943).

13 Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943).

14 74 Stat. 887 (1960), 15 U.S.C. § 80b-6(4) (Supp. III, 1961).

15 *Hearings on S. 1178 to S. 1182*, *supra* note 9, at 516-17. At the same time, the SEC pointed out that "the language of section 206, making it unlawful to employ any device to defraud a client, or to engage in any transaction which operates as a deceit upon a client, are modeled on clauses (1) and (3) of section 17(a) of the Securities Act of 1933. Under that section the common law deceit concepts no longer acted as a bar to the defrauded buyer. . . . Therefore, a question arises as to the SEC's claim that it has been limited by these concepts under section 206." *Id.* at 516-17.

16 See S. REP. No. 1760, 86th Cong., 2d Sess. 8 (1960).

17 That such a relationship should exist was expressly approved by the majority. Principal case at 608.

18 SEC Securities Act Release No. 3043, Feb. 5, 1945.

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

advice is in the best interests of his clients. Yet he is not disinterested if he himself is also a beneficial owner of a recommended stock. Viewed against this background, the weight given by the majority of the court to the SEC's pronouncements before Congress, without an actual examination of the relationship between the investment adviser and his customers or the duties to which that relationship might give rise, is seemingly unjustified.

In *SEC v. Torr*,[20] the presence of an undisclosed personal interest, economically similar to that of the defendants in the principal case, was held to constitute a violation of section 17(a)(1) of the Securities Act. There, certain defendants recommended the purchase of a particular stock without disclosing that they were to receive bonuses on those purchases resulting from their recommendations. Judge Patterson stated that it was plain enough that this selling campaign "operated as a deceit on purchasers."[21] The majority in the principal case approved the *Torr* decision, but apparently sought to distinguish it factually. In contrast to *Torr*, the majority declared that "the SEC's proof tends only to show that, at most, defendant . . . profited personally from the predictable market effect of his honest advice."[22] Yet, in *Torr*, it could be said with equal accuracy that defendants merely profited from the predictable market effect of their "honest" advice. As in the principal case, there was nothing to indicate that any defendant misrepresented any fact bearing on the intrinsic worth of the recommended stock. Nor can the cases be convincingly distinguished on the basis of the relatively slight difference between the personal interests of the respective defendants. Though *Torr* was, of course, a Securities Act case, the origin of clauses (1) and (2) in section 17(a) and the policy of Congress in favor of a broad construction of the securities laws suggest that clauses (1) and (2) should be interpreted with the same justifiable liberality which has been applied to the Securities Act generally, and, specifically, that defendants' conduct in the principal case was, indeed, within the scope of those provisions.[23]

The SEC's new rule-making power under clause (4) appears to have influenced the majority's determination to a large extent. The majority chose not to decide whether the first sentence, declaring fraudulent, de-

20 15 F. Supp. 315 (S.D.N.Y. 1936), *rev'd on other grounds*, 87 F.2d 446 (2d Cir. 1937).

21 *Id.* at 317. "When a person gives advice to buy a stock under circumstances that lead the listener or reader to believe that the advice is disinterested, and suppresses the fact that for giving such advice he is in reality being paid by one anxious to sell the stock, the purchaser acting on the advice is imposed upon and deceived." *Ibid.*

22 Principal case at 609.

23 In an opinion of James A. Treanor, Jr., Director of the Trading and Exchange Division, it was said: "An investment adviser is a fiduciary. As such he is required by the common law to serve the interests of his client with undivided loyalty. In my opinion a breach of this duty may constitute a fraud within the meaning of clauses (1) and (2) of section 206 of the Investment Advisers Act (as well as the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934)." SEC Securities Act Release No. 3043, Feb. 5, 1945. A similar position has been taken by Professor Loss. See 3 Loss, *op. cit. supra* note 2, at 1515.

ceptive, or manipulative practices unlawful, was intended to be self-operative, that is, whether it could be invoked without the antecedent promulgation of regulations by the SEC. That such was the apparent intent of Congress in the enactment of clause (4), however, would seem to follow from the fact that its language was derived substantially from section 15(c)(2) of the Securities Exchange Act of 1934, a provision generally agreed to be self-operative.[24] In spite of the pronounced similarity between these two sections in both language and purpose, the majority went on to express a definite preference for antifraud enforcement under detailed Commission rules, rather than through the judicial interpretation and application of broad statutory provisions.[25] It would be unfortunate, however, if detailed regulations were to become the sole effective means of enforcing section 206. The promulgation of such rules is an uncertain and time-consuming process,[26] and, if such rules must be applicable only to specific types of fraudulent activities before the courts will view them favorably, schemes may easily be devised to avoid their limited impact. The congressional desire to strengthen the antifraud provisions of the Investment Advisers Act would be better served by a finding that the first sentence of clause (4) is self-operative, and by ascribing to it, and to rules created under clause (4), the liberal construction common to other securities laws.

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24 48 Stat. 895, as amended, 49 Stat. 1378 (1936), added by 52 Stat. 1075 (1938), 15 U.S.C. § 78o(c)(2) (1958); 3 Loss, *op. cit. supra* note 2, at 1425-26, 1517.

25 In its original opinion, the majority said: "[I]t seems appropriate that courts in piecemeal fashion do not try to take over the regulatory function of the SEC and single out a rather small advisory service and hold it in advance of trial responsible for violation of a rule which has not yet been promulgated and as to which there is no certainty that it ever will be." SEC v. Capital Gains Research Bureau, Inc., 300 F.2d 745, 751 (2d Cir. 1961).

26 Judge Clark said in dissent: "Some of my brothers seemingly draw some comfort in believing that the destructive effect of this construction of the statute will be limited in effect and duration because of powers now granted to the SEC by the 1960 amendment to the statute. . . . The thought seems to be that the SEC will hereafter outlaw the defendants' activities by regulation. This suggests an easy solution to a problem which is obviously bemusing the court. But like many an 'easy' solution it becomes in reality the harder one because of the difficulties it creates. Among those difficulties are those of time, of power and validity of the indicated action, of legislative policy in the premises, and of potential paralysis of agency action and the execution of Congressional policies." Principal case at 618.