Boston College Law Review

Volume 5 | Issue 3 Article 33

4-1-1964

Securities—Investment Advisers Act—Requirement of Full Disclosure.—Securities Exchange Comm'n v. Capital Gains Research Bureau

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Recommended Citation

Dwight W. Miller, *Securities—Investment Advisers Act—Requirement of Full Disclosure.—Securities Exchange Comm'n v. Capital Gains Research Bureau*, 5 B.C.L. Rev. 838 (1964), http://lawdigitalcommons.bc.edu/bclr/vol5/iss3/33

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that special circumstances caused special damages or that the collateral was worth more than the debt it secured but was sold on default for less.[30]

There is no gainsaying that proving loss by this method is relatively speculative and opens the door to possible fraud. Nevertheless, a mature consideration of the equities involved may in the future induce an adventurous court with a "hard" case before it to adopt the procedure suggested. Until that time, however, it would be fair to say that the rule in *Skeels* is likely to be followed.

STUART L. POTTER

Securities—Investment Advisers Act—Requirement of Full Disclosure.—*Securities Exchange Comm'n v. Capital Gains Research Bureau.*[1]— The SEC sought an injunction[2] prohibiting Capital Gains from making any recommendations of stock in its advisory bulletin without disclosing to its clients its own intention to purchase or sell that stock in the near future. Capital Gains distributes monthly to five thousand clients a bulletin describing and recommending stocks it considers worthwhile for long-term investment. On six occasions in 1960,[3] Capital Gains bought shares of a stock just prior to recommending this stock in its bulletin.[4] Each time, within two weeks after mailing the bulletin, these shares were sold at a profit. The SEC contended that the sequence of purchase, recommendation, and sale constituted a violation of the antifraud section[5] of the Investment Advisers Act of 1940.[6] The District Court denied the motion for the injunction;[7] a panel of the Court of Appeals[8] and the Court of Appeals *en banc* affirmed.[9] The United States Supreme Court, in reversing, HELD: That Capital Gains had breached its fiduciary duty to its clients by not fully disclosing its in-

[30] For example, if the debt is $500 and the collateral securing it is worth $650 but is sold without notice in a commercially reasonable manner for $400, then the deficiency would be $100 but the loss sustained by the debtor who could prove he had the resources and the willingness to redeem or "buy in" is $50 more. He would have paid his debt of $500 and redeemed collateral worth $650.

[1] 375 U.S. 180 (1963).

[2] Id. at 183 n.5, for the requested injunction in full.

[3] The six stocks were: Continental Insurance Co.; United Fruit Co.; Creole Petroleum Corp.; Hart, Schaffner & Marx; Union Pacific; and Frank G. Shattuck Co.

[4] On one occasion Capital Gains sold short shares of a security immediately before stating in its bulletin that the security was overpriced. After the publication of the bulletin, they profitably covered their short sales.

[5] It shall be unlawful for any investment adviser under § 80b-3 of this title, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.

[6] 54 Stat. 847 (1940), as amended, 15 U.S.C. § 80b (Supp. IV, 1961).

[7] 191 F. Supp. 897 (S.D.N.Y. 1961).

[8] 300 F.2d 745 (2d Cir. 1961).

[9] 306 F.2d 606 (2d Cir. 1962).

terest, and such non-disclosure constituted fraud and deceit within the meaning of the Investment Advisers Act.

It is clear from earlier cases[10] and from both the majority[11] and minority[12] opinions in this case that the relationship between an investment adviser and his clients is of a fiduciary nature. The distinction between the holding of the majority, speaking through Justice Goldberg, and the dissenting opinion of Justice Harlan seems to hinge on what constitutes a breach of the fiduciary duty under the Investment Advisers Act. The majority stated that the investment adviser represents his disinterest in the advice he gives and that his only financial concern is his commission or subscription rate. Such an adviser cannot claim to be disinterested if he is the beneficial owner of stock held for a short term investment which he has recommended to his clients for long-term investment. The adviser is benefited upon his sale of the stock when it rises on the market shortly after he recommends it in his bulletin. It does not tax one's imagination to conceive of situations where this interest could adversely effect the client's interests in being fully informed about the securities discussed in the bulletin. Suppose that an adviser had decided to recommend a particular security and, while the recommendation was being prepared, had purchased the stock. If at that point they learned something which reflected adversely in the stock, perhaps a confidential report that the company's earnings had taken a downward turn, would they change their recommendation and thus suffer a possible loss on the securities already purchased—or would the loss be passed on to those clients who followed the advice?[13]

The dissent and the lower courts held that there is no breach of that fiduciary duty established in the Investment Advisers Act unless there is proof that the recommendations were made with the knowledge that the stock was not a valid long-term investment. If the dissent's view had been accepted then the SEC, in fact situations similar to the one in this case, would have to prove a deliberate fraud as to the actual content of the recommendations, which seems impossible in any but the most flagrant cases. Such a burden on the SEC would far exceed that imposed on it by any other securities regulation acts.[14] Rather, as the majority points out,[15] even though the recommendations are made with belief in their worthiness as long-term investments, the danger of subconscious, or even conscious prej-

[10] Seipel v. SEC, 229 F.2d 758 (D.C. Cir. 1955); SEC v. Torr, 15 F. Supp. 315 (S.D.N.Y. 1936), rev'd on other grounds, 87 F.2d 446 (2d Cir. 1937); Ridgely v. Keene, 134 App. Div. 647, 119 N.Y.S. 451 (1909).

The duties of disclosure were recently enlarged for the individual who represents that he is a specialist. In Berko v. SEC, 316 F.2d 137 (2d Cir. 1963), the court required a "boiler-room" operator before he advertises the worth of a stock to have made sufficient investigation to know the truth of what he says. If the regulation is ever found desired, it is possible to see this same interpretation of the disclosure rule applied to investment advisers.

[11] Supra note 1, at 194.

[12] Id. at 203.

[13] Brief for Petitioner, p. 17.

[14] For a discussion of this point, anticipating the noted result, see 4 B.C. Ind. & Com. L. Rev. 210 (1962).

[15] Supra note 1, at 188.

udice, in favor of one's own financial interest is too great to allow non-disclosure by investment advisers in these situations.

There have been few injunctive actions brought under section 206, the anti-fraud provision of the Investment Advisers Act, and only one other case than the principal one that was contested. That case was affirmed per curiam in favor of the SEC.[16] *Capital Gains* is the first case in which the Court has had the opportunity to decide what degree of disclosure will be required of investment advisers who are not also broker-dealers and thus subject to other security acts.

In a similar fact situation disclosure was required of broker-dealers under the Securities Act of 1933.[17] In *SEC v. Torr*,[18] non-disclosure similar to that of the principal case was held to be a violation of the antifraud provisions of both the 1933 and 1934 Securities Acts. In the *Torr* case, the defendants recommended the purchase of stocks without disclosing to their clients that they were to receive bonuses for any sales of this stock resulting from their recommendations. As in the instant case, there was nothing to indicate that the defendants misrepresented any fact bearing on the intrinsic worth of the recommended stock.[19] However, the court decided that the fiduciary duty owed to the clients was breached and such action by the broker-dealers constituted fraud under the relevant provisions of the Securities Act of 1933. The facts of the *Capital Gains* case cannot be readily distinguished from those in *Torr*. However, the *Torr* decision was decided under the Securities Exchange Act of 1934, not the Investment Advisers Act, and only in form does it support the present case.

The Securities Act specifically makes failure to disclose material facts to clients unlawful,[20] while the Investment Advisers Act does not so specify, but rather contains just a broad antifraud provision.[21] However, in an admirable performance of statutory amplification, the Court indicates that the disclosure required of broker-dealers by the 1933 and 1934 Securities Acts should also be required of investment advisers by the antifraud provisions of the Investment Advisers Act. As Justice Goldberg states, the Se-

[16] Seipel v. SEC, supra note 10. The court enjoined defendant's practice of representing to persons answering his ads that guaranteed his advice against loss and he had had 25 years trading experience. In fact he had no customers or experience.

[17] 48 Stat. 881 (1934), 15 U.S.C. §§ 77a-77aa (1948).

[18] Supra note 10.

[19] See generally Norris & Hirshberg, Inc. v. SEC, 177 F.2d 228 (D.C. Cir. 1949); Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943); Archer v. SEC, 133 F.2d 795 (8th Cir. 1943).

[20] 48 Stat. 84 (1933), 15 U.S.C. § 77q(a) (1948), provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or 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 or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud upon the purchaser.

[21] Investment Advisers Act, § 80b, supra note 5:

curities Act, the Investment Advisers Act, and the other related securities acts of this period[22] were all promulgated by Congress with the purpose "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* . . ."[23] in the securities field. It would seem that the same reasons for giving a broad interpretation to the material facts disclosure provision of the Securities Act, would also hold true for a similar interpretation of the antifraud provision of the Investment Advisers Act. Congress has seen the need for general and flexible antifraud provisions in the field of securities regulation in order to control "the versatile inventions of fraud-doers."[24] Were it otherwise, if, instead of court supervision, the Act had been made more specific in its proscriptions or if SEC rules had required disclosure of specific facts, then schemes or practices could be invented by the advisers to circumscribe such rules or provisions.[25]

The dissent pointed to the omission of a provision for the disclosure of material facts in the Investment Advisers Act along with the 1960 amendments[26] giving the SEC rule-making power in the area of fraud among advisers. This would seem to manifest a congressional intent that more than mere non-disclosure is necessary to constitute fraud under the Investment Advisers Act.[27] However, even though the Commission could promulgate a rule to prevent specific practices such as in this case, such a rule would not be the total answer. It would seem better to leave, as the majority does, some discretion with the courts to handle problems of conflicts of interests in this field. The majority decided that this could be accomplished if the Investment Advisers Act is construed with its predecessors and related acts *mutatis mutandis*.[28]

This decision gives the investment adviser some idea of what practices will not be allowed under the antifraud provision of the Investment Advisers Act as interpreted by this Court. Clearly, trading by an adviser on his own account in the same stock he has recommended without adhering to the content of his recommendation is prohibited as demonstrated by the instant case and the *Torr* decision.[29] For example, as in *Capital Gains*, an adviser may not advise long-term investment and himself buy it for a short-swing profit. Hence, the Court has not held that a broker-dealer or adviser is absolutely prohibited from trading on his own account stock

[22] Public Utility Holding Company Act of 1935, 49 Stat. 838 (1935), 15 U.S.C. §§ 79-79z (1948); Trust Indenture Act of 1939, 53 Stat. 1149 (1939), 15 U.S.C. §§ 77aaa-77bbbb (1948).

[23] Supra note 1, at 186.

[24] Id. at 199.

[25] Id. at 193 n.41.

[26] Supra note 6.

[27] The dissent finds support for its interpretation from the Senate report: "This provision [1960 amendments] 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." S. Rep. No. 1760, 86th Cong., 2d Sess. 8 (1960).

[28] 3 Loss, Securities Regulation 1515 (2d ed. 1961). Also see the SEC Release No. 3043, Feb. 5, 1945, stating that the provisions of the Investment Advisers Act and the Securities Act call for the same type of fiduciary duty.

[29] See Arleen Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949); Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943).

which he has recommended, but rather only that the adviser must disclose his trading on his own account that is in any sense inconsistent with the recommendation he has given his clients.[30]

An adviser will be unable to circumvent the holding of the principal case by having his wife or other member of his immediate family trade in the stocks recommended, if such trading is not consistent with the advice offered. In the case of *In Re Midland United Co.*,[31] where the wife of an attorney, who had confidential information concerning securities, was trading in these stocks, the court said it was justified in

> extending the principles applicable to the conduct of the fiduciary to the fiduciary's wife. The settled rule in equity is that where a fiduciary is barred from compensation the prohibition extends to his wife.[32]

However, if the fiduciary, in our case an investment adviser, has no knowledge of his wife's dealings in the securities, there is authority that such transactions will not constitute fraud.[33] The *Torr* case stated that disclosure to the client is required if the adviser is being paid by an issuer or other interested party to favorably report a stock. An eventual result of *Torr* and *Capital Gains* would be to require an adviser to disclose any substantial interest he might have in a corporation whose stock the adviser recommends.

The Court, in this first contested case concerning fraud under the Investment Advisers Act, while not prohibiting all trading on personal accounts in recommended stock, has required disclosure where there is any possibility of a conflict, and in so doing has followed the course which other courts have taken in similar cases under the related securities acts. The result reached in this case is desirable in light of the possible opportunities for abuse by investment advisers and the lack of flexible means and remedies to protect the buying public.

DWIGHT W. MILLER

Trade Regulation—Robinson-Patman Act—Substantial Lessening of Competition Not Proven by Short-Term Discounts.—*American Oil Co. v. FTC.*[1]—This was a petition from an FTC cease and desist order wherein the petitioner was charged with price discriminations in violation of Section 2(a) of the Robinson-Patman Act.[2] American Oil Co. employed as part

[30] Supra note 1, at 196.
[31] 159 F.2d 340 (3d Cir. 1947).
[32] Id. at 347.
[33] In re Philadelphia & Reading Coal & Iron Co., 61 F. Supp. 120 (E.D. Pa. 1945).

[1] 325 F.2d 101 (7th Cir. 1963).
[2] 49 Stat. 1526 (1936), 15 U.S.C. § 13(a) (1958). Section 2(a) of the act, as amended, provides in pertinent part:

> It shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, . . . where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competi-