Securities—Investment Adviser Act—Failure to Disclose Adviser's Position in Market with Respect to Stock Recommended to Subscribers.—*SEC v. Capital Gains Research Bureau, Inc.*[1]—Captain Gains is operated as a registered investment advisory service under the control of Schwarzmann, the sole owner. It published two bulletins: "Facts on Funds" followed the changes in the portfolios of mutual funds (not under attack); "Special Bulletin" analyzed a particular corporation recommended to subscribers for long term capital investment. The latter publication was mailed to 5,000 subscribers and occasionally to 100,000 non-subscribers. Seven bulletins, published between March, 1960 and October, 1960 are the basis of the SEC complaint: in recommending the purchase of six corporate stocks,[2] Capital Gains failed to disclose that, just prior to recommending them, it had purchased the stocks; and that, within a few days after mailing the Bulletin, it sold the same stocks at a profit. Suggesting in a seventh Bulletin that a stock (Chock Full o'Nuts) was overvalued, Capital Gains covered a short sale when the market price dropped. Alleging violation of the antifraud section, 206(1) and (2),[3] of the Investment Advisers Act of 1940,[4] the SEC sought a preliminary injunction and final injunction enjoining the use of "any device, scheme, or artifice to defraud any client or prospective client," or "any transaction, practice and course of business which operates as a fraud or deceit upon any client or prospective client." The District Court denied the motion for preliminary injunction;[5] a panel of the Court of Appeals affirmed.[6] Upon rehearing, the Court of Appeals *en banc* affirmed (5-4). HELD: The methods employed by the defendant do not constitute a scheme or device to defraud clients. It is merely shown that the defendant profited from its own considered advice.

To appreciate the consequences of the decision in *Capital Gains,* it is necessary to examine the legislative history of the Investment Advisers Act, a new and embryonic being when compared with the ancient contrapuntal factors of common law deceit[7] which must now be superimposed upon security legislation.

The magic date in securities legislation is 1933. Prior to that time, the ability of the federal government to prosecute fraudulent practices in the securities field was limited to violations of the mail fraud statute.[8]

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1 CCH Fed. Sec. L. Rep. ¶ 91,166 (2d Cir. July 13, 1962).

2 Continental Insurance, Creole Petroleum, Union Pacific, Hart, Schaffner and Marx, and United Fruit.

3 It shall be unlawful for any investment adviser registered 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.

4 54 Stat. 847 (1940), 15 U.S.C. § 80b (1948), as amended, 74 Stat. 888 (1960), 15 U.S.C. § 80b (1961 Supp.).

5 191 F. Supp. 897 (S.D.N.Y. 1961).

6 300 F.2d 745 (2d Cir. 1961).

7 Restatement, Torts, §§ 525-52 (1938).

8 35 Stat. 1130 (1909), 18 U.S.C. 338 (1940), as amended, 62 Stat. 763 (1948), as recodified, 63 Stat. 94 (1949), 18 U.S.C. 1341 (1958).

Section 17(a) of the 1933 Securities Act[9] delineated three offenses specifically designed to cover the niceties of the flotation of securities. Similar anti-fraud sections appeared in 1934 legislation.[10] The Investment Advisers Act resulted from a study by the Commission of investment companies and investment trusts. In a supplemental report on investment advisers[11] it was found that investment counseling had gained impetus as an occupation after World War I.[12] Recognizing the influence of investment advisers over the national economy and the existence of abuses in the field,[13] Congress passed the act on August 22, 1940.

The act encompasses all individuals, partnerships and corporations which for compensation engage in the business of advising others as to the value of securities and the advisibility of investment.[14] Advisers are required to register with the Securities and Exchange Commission and furnish limited information about themselves.[15] The term "compulsory census" entered the

9 48 Stat. 74 (1933), 15 U.S.C. § 77q(a) (1948). Section 17(a) states:

> 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 use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
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> (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 to make the statement 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 or deceit upon the purchaser.

10 Sections 10(b) & 15(c)(1), Securities Exchange Act, 48 Stat. 881 (1934), 15 U.S.C. §§ 78j(b), 78o(c)(1) (1948).

11 H.R. Doc. No. 477, 76th Cong., 2d Sess. (1939), as cited by Loomis, The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940, 28 Geo. Wash. L. Rev. 214 (1959).

12 7 Ann. Rep. of the SEC 34 (1941). In 1898 only one investment adviser was recorded. In 1930 the number had risen to 29. As of June 30, 1961, there were 1855 registrants. 27 Ann. Rep. of the SEC 160 (1961). The Commission and members of the industry acknowledged that legislation in the field was needed to discourage persons lacking qualifications from "using a professional status as a cloak to cover up larceny or any illegal operations." Hearings on S. 3580 Before the Subcommittee of the Committee on Interstate and Foreign Commerce of the House of Representatives, 76th Cong., 3d Sess. 87 (1940).

13 Loomis, supra note 11, at 244. Among the abuses mentioned were: the fraudulent activities of "tipster" organizations; possible conflicts of interest; the existence of contracts providing for the adviser's compensation on a "heads I win, tails you lose" basis.

14 Exempted from registration are: newspapers, magazines and financial publications of general and regular circulation; brokers whose advice is merely incidental to regular business transaction for which no special fee is charged; banks, lawyers, accountants, engineers and teachers whose advisory service is incidental in their professional practice. 7 Ann. Rep. of SEC, supra note 12, at 29-30.

15 On initial registration one application was withdrawn at the Commission's suggestion. The applicant had been in the Wisconsin State Prison since 1930 on a charge of assault with intent to murder, and was not subject to parole until 1942. Id. at 31. The Commission may, under § 203(d), deny registration if within ten years prior to registering the applicant has been enjoined for financial fraud; found to have submitted a misleading application; or convicted of a crime concerned with a security fraud. See, e.g., George C. Crowder, 8 SEC Dec. and Rep. 947 (1941).

lexicon of administrative jargon.[16] Although section 80b-17 makes willful violation of the act a felony,[17] license revocations and injunctions have been the Commission's customary enforcement techniques.[18]

That there have been few cases under the act appears attributable not so much to a well-regulated industry as to the deficiencies of the act. The 1942 Annual Report of the SEC noted the absence of power to make periodic checks of the accounts and records of the registrants as they were empowered to do under Section 17(a) of the 1933 Securities Act. "This omission leaves entirely unsupervised and unprotected a broad field in the handling of investment funds of the general public."[19] Despite frequent urging by the SEC[20] it was not until 1960 that amendments were passed,[21] making it unlawful for registrants to engage in fraudulent, deceptive or manipulative procedures; the Commission was directed to set up rules to this end.

The common law concepts of deceit[22] present a difficult if not insurmountable context for the statutory fraud measures of the legislation in question.[23] The courts have recognized that the "intricate merchandise"[24] involved necessitated protection for the unsophisticated investor;[25] "the fact is that the courts have repeatedly said that the fraud provisions in the SEC acts, as well as the mail fraud statute, are not limited to circumstances which would give rise to a common law action for deceit."[26]

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16 Hearing on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. Part 1 at 48 (1940).

17 United States v. Hageman, Litig. Rels. 670, 789, 791 (S.D.N.Y. 1953).

18 Injuctions were granted in SEC v. Dyer, Inv. Adv. Act Rel. No. 28 (Denver, Colo. 1942) (defendant purported to use a "unique scientific formula"); SEC v. Lubbe, Litig. Rel. 72 (S.D. Ill. 1943); SEC v. Greenamn, Litig. Rel. 977, 982 (D. Utah 1956) (defendant speculated in worthless uranium stock); SEC v. Henry Helser & Co., Litig. Rel. 878, 915, 1095 (N.D. Cal. 1955, 1957) (defendants could have been enjoined but were allowed a stay to mend their ways which was not done, final injunction being entered Mar. 22, 1957). In People v. Goldsmith, 86 N.Y.S.2d 12 (1948), defendant represented to the public that he had a special system. He failed to disclose that this was the analysis of comic strips. He had "learned" the code during a seance with a departed securities speculator.

19 8 Ann. Rep. of SEC 36 (1942).

20 15 Ann. Rep. of SEC 160 (1949). "The Commission has received a substantial number of complaints against certain investment advisers whose advice consists chiefly of predictions and recommendation furnished in bulletins, market letters, and other publications issued periodically and sold at a regular subscription price. The number of complaints generally increase . . . as the market declines. Because of these limitations [of inadequate powers of inspection] . . . a broad field intimately related to the securities market is left unprotected and unsupervised, and the Commission's efforts to enforce the act are greatly curtailed." 22 Ann. Rep. of SEC 193 (1956).

21 74 Stat. 887 (1960), 15 U.S.C.A. § 80b (1961 Supp.). See generally 2 U.S. Code Cong. & Ad. News 3502-11 (1960).

22 Prosser, Torts 523 (2d ed. 1955). Proof of a (1) false representation of a (2) material (3) fact; (4) the defendant must make it to induce reliance; (5) the plaintiff must rely on the false representation; and (6) suffer damage as a consequence.

23 3 Loss, Securities Regulations 1430-44 (2d ed. 1961); Shulman, Civil Liability and the Securities Act, 43 Yale L.J. 227 (1933).

24 H.R. Rep. No. 85, 73d Cong., 1st Sess. 8 (1938).

25 Charles 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, 803 (2d Cir. 1943), cert. denied, 319 U.S. 767 (1943).

26 3 Loss, op. cit. supra note 23, at 1435 n.19 citing cases.

The leading case of *Charles Hughes & Co. v. SEC*[27] is illustrative of the traditional position. In referring to the fraud aspects of the broker's conduct, Judge Clark remarked:

> We need not stop to decide, however, how far common law fraud was shown. For the business of selling investment securities has been one peculiarly in need of regulation for the protection of the investor.[28]

This contention was reiterated in *Norris & Hirshberg, Inc. v. SEC*[29] in 1949. In the *Arleen Hughes* case,[30] defendant, registered as both a broker-dealer and as an investment adviser, did not inform clients of her adverse interest in the market. The court acknowledged that the securities field, "by its very nature, requires specialized and unique legal treatment. This is recognized by the very statutes and regulations here under consideration as well as by recent federal and state court decisions."[31] Emphasis was given to the point that proof of loss, one of the common law deceit requirements, is not a consideration under the 1933 Securities Act. Revocation of her license as a broker-dealer was proper if one or none of her clients suffered injury.[32] These decisions reflect the courts' recognition of the need, which the Second Circuit appears to have overlooked, for effective regulation in the security field and, in addition, that the common law concepts of deceit should not confine the needed effectiveness. In *Capital Gains* the court retreats from this position. (In commenting on the case before the rehearing, Professor Loss states, "The SEC suffered a defeat, whose dimensions are not altogether clear. . . .")[33]

The majority opinion in *Capital Gains* cites *SEC v. Torr*[34] with approval.[35] That this case does not support their conclusion is correctly noted by the dissent of Judge Clark. In *Torr*, stock was touted to customers and the defendants were secretly compensated. The stock was of a reputable firm and no misrepresentations were made. However, no disclosure was made of the plan to create trading in the recommended stock. "In principle there is no difference between the method of recommendation pursued here and the hired employment of a tipster sheet that purports to give impartial informa-

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[27] Supra note 25.

[28] Id. at 437.

[29] 177 F.2d 288 (D.C. Cir. 1949).

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

[31] Id. at 975.

[32] Accord, SEC v. Torr, 15 F. Supp. 315, 317 (S.D.N.Y. 1936), rev'd on other grounds, 87 F.2d 446 (2d Cir. 1937).

[33] 3 Loss, op. cit. supra note 23, at 11 (1962 Supp.). See also Note, 75 Harv. L. Rev. 1450 n.6 (1962); Note, 71 Yale L.J. 1342, 1347 (1962).

An example of activity enjoined under §§ 206(1) and (2) of the act under present consideration is provided by Seipel v. SEC, 228 F.2d 758 (D.C. Cir. 1955). In a per curiam opinion, the court enjoined defendant's practice of representing to persons answering his ads that he guaranteed against loss and maintained extensive offices with a foreign exchange department. He alleged he had had 25 years trading experience and many clients. In fact he had no office, associates, organization or customers.

[34] Supra note 32.

[35] Supra note 1, ¶ 93,821.

tion."[36] It is submitted that the facts of the instant case differ only slightly. Nevertheless, it is to be noted that in the foregoing cases, with the exception of *Seipel*,[37] the courts were dealing with brokers and not with investment advisers.

The crux of the decision in the instant case centers on the characterization of Capital Gains Research Bureau. Although official pronouncements of the Commission have dealt specifically with the situation of an investment adviser acting also as a principal for a client pursuant to section 206(3), his capacity has been regarded as that of a fiduciary.[38] That this should be his status cannot be doubted if the remedial purposes of the legislation are to be realized. Peculiarly, the majority opinion concedes this point; it notes that federal securities laws, in light of their objectives, should be broadly construed. It is therefore difficult to follow the reasoning of the court when it thus premises its decision but ultimately retreats into a narrow interpretation of section 206(1) and (2) in terms of technical fraud.

Precedent for the majority position may be found in *SEC v. Todd*[39] or in *Hughes v. SEC*.[40] The stated rationale for their statutory interpretation of the act lies in its legislative history: it was not as comprehensive as its forerunners; subsequent legislation has been needed to round out its piecemeal measures; the antifraud section is "deliberately meagre." The new paragraph added in 1960, 206(4), makes it unlawful for advisers to pursue fraudulent, deceptive or manipulative practices. The Commission has been directed to define such practices and set out rules to prevent them.[41] The strongest language in support of the majority opinion is in the Senate report: "This provision 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."[42] However, it may be questioned if this language should be the basis of cutting down the force of section 206(1) and (2). Rules promulgated after the sharp practice is discovered cannot be said to be the entire answer. Indeed, even if the foregoing be accepted, the wisdom of the majority contention that fraud must be defined by the Commission remains a question of serious doubt.[43]

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36 Id. at 317.

37 Seipel v. SEC, supra note 33.

38 Opinion of the Trading and Ex. Div. of SEC, Rel. No. 40, Feb. 5, 1945.

39 Litig. Rel. 372, 15 Ann. Rep. of SEC 161 (D. Mass. 1946, 1948). Action was dismissed after a showing that the provable facts would not support a conviction.

40 Supra note 31, at 977. "Our entire opinion concerns itself only with the revocation of petitioner's *broker-dealer registration*. There is nothing in the record before us which in any way attacks her *investment adviser* registration, which registration, we presume, is still in full force and effect." (emphasis original) But cf. 3 Loss, op. cit. supra note 23, at 1515 n.118 which states that this result could not occur under the 1960 amendment.

41 3 Loss, op. cit. supra note 23 (1962 Supp. at 13-14); 2 U.S. Code Cong. & Ad. News, supra note 21, at 3504.

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

43 3 Loss, op. cit. supra note 23, at 1436. "The courts have traditionally refused, whether at common law deceit or under security laws, to define fraud with specificity." Loss cites the Oregon court's pronouncement in State v. Whiteaker, 118 Ore. 656, 661, 247 Pac. 1077, 1079 (1926), that to do so would create "a certain class of gentlemen of the 'J. Rufus Wallingford' type—'they toil not neither do they spin'—who would

It is submitted that the dissent, led by Judge Clark, presents the preferable view. The Investment Advisers Act should not be given a poor relative standing, but should be construed with its predecessors *mutatis mutandis*.[44] The case reinstates all the former uncertainty as to the meaning of antifraud sections of securities legislation with an apologia of "everybody wins all around." Cited as the "worst feature" by the minority is that indulgence instead of opprobrium should be given to the scalping practice utilized by those with a low standard of business practice. Appropriate to this position is the oft-quoted passage from *Archer v. SEC*:[45]

> 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 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.

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Taxation—Use of Cash in Type B Reorganization.—*Turnbow v. Commissioner*.[1]—Petitioner owned all of the 5,000 shares of outstanding stock in the International Dairy Supply Co., which shares he transferred in 1952 to Foremost Dairy Company. He received in exchange 82,375 shares (a minor percentage) of Foremost's common (voting) stock of a fair market value of $1,235,625, plus a boot in the amount of $3,000,000. The gain realized by the taxpayer on the exchange—*i.e.*, stock and cash in excess of the basis of his own stock and expenses—was $4,163,691.94.[2]

lie awake nights endeavoring to conceive some devious and shadowy way of evading the law. It is more advisable to deal with each case as it arises."

44 3 Loss, op. cit. supra note 23, at 1515.

45 133 F.2d 795, 803 (8th Cir. 1943), cert. denied, 319 U.S. 767 (1943).

1 368 U.S. 337 (1961).

2 The following is the statutory complex from which the *Turnbow* and *Howard* issues arise.

Int. Rev. Code of 1939:

§ 112(b)(3) . . . No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

§ 112(c)(1) . . . provides further, "if an exchange would have qualified under § 112(b)(3) but for the receipt of cash or property (boot) other than the permissible stock or securities, then the gain will not be recognized in full but will be recognized only in an amount not in excess of the boot."

§ 112(g)(1)(B) . . . by definition the term "reorganization" means "the acquisition by one corporation in exchange solely for all or a part of its voting stock, of at least 80 percentum of the stock of another corporation."