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Securities--Investment Advisers Act--"Scalping" Held To Be Fraudulent Practice (SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963))

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and that the contract need not contain a provision requiring notice to be transmitted to him. The designated tribunal can then adjudicate any conflicts arising out of their contractual relationship.

In the present case, this consent was achieved through use of a contractual designation of an agent for service of process in such foreign forum. The Court stated that due process was satisfied even though the contract did not provide for notice to be given to the defendants. The principal case would not appear to sustain jurisdiction on similar facts if no effort is made to give the defendant actual notice. However, the Court did not consider a situation in which no such notice had been given.

It is now certain that such in personam jurisdiction can be obtained in the chosen forum without violating due process. That conclusion has no bearing, however, on the doctrine of forum non conveniens, which may cause the court to refuse to entertain the case though it has unquestionably acquired jurisdiction.[32]

It is probable that the state courts will now more readily uphold the validity of such contractual designation. Since the constitutionality of this clause has been upheld we can expect an ever increasing use of such consent jurisdiction.

SECURITIES — INVESTMENT ADVISERS ACT — "SCALPING" HELD TO BE FRAUDULENT PRACTICE. — Defendant, a registered advisory service,[1] published a report which apprised its five thousand[2] subscribers of the investment potential of particular stocks. The service, on at least five occasions, purchased listed stocks and, without disclosing these prior purchases, recommended such stocks for long-term investment. Following each recommendation the price of such shares rose, and within two weeks the defendant sold its shares at a substantial profit. The SEC, alleging violation of the Investment Advisers Act of 1940 [hereinafter referred to as the Act] commenced a proceeding to enjoin this practice.

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[32] Emerson Quiet Kool Corp. v. Eskind, 32 Misc. 2d 1037, 228 N.Y.S.2d 839 (Sup. Ct. 1957).

[1] "'Investment Adviser' means any person who, for compensation, engages in the business of advising others, either directly or through publication or writings, as to the value of securities. . . ." Investment Advisers Act § 202 (a)(11), 54 Stat. 847 (1940), 15 U.S.C. § 80b-2 (11) (1958). It is unlawful for an unregistered investment adviser to use the mails or any other means of interstate commerce in connection with his advisory business. Investment Advisers Act § 203(a), 54 Stat. 850 (1940), 15 U.S.C. § 80b-3 (a) (1958).

[2] On several occasions the report was distributed to an additional 100,000 non-subscribers. SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606, 612 (2d Cir. 1961) (Clark, J., dissenting), *rev'd*, 375 U.S. 180 (1963).

Reversing both lower courts the United States Supreme Court *held* that the defendant's practice, known to the trade as "scalping," operates as such "fraud or deceit" on a client as to be within the prohibitions of the Act, even though neither intent to injure, nor actual injury was shown. *SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963).

Stock "scalping" consists of realizing a short-term profit on the direct or secondary market reaction to one's own advice.[3] The reaction is swift and certain, since generally only a small percentage of the outstanding shares of most listed corporations are actually traded[4] and a relatively small increase in demand can significantly increase the price.[5]

Prior to the principal case there had been only a few injunction proceedings concerning the anti-fraud provisions of the Act, most of which were uncontested and none of which reached the Supreme Court.[6] The Act in part provides that:

> It shall be unlawful for any investment adviser . . . 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. . . .[7]

The paucity of case law, however, does not prevent a detailed study of the subject since the fraud provisions of the Act are substantially the same as the fraud provisions of the Securities Act of 1933,[8] and the SEC Rule 10b-5,[9] both of which have been the subject of exhaustive judicial interpretation. The decisions under these provisions are instructive since words having a well-known meaning in an act, are presumed to have the same meaning

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[3] *Id.* at 613.

[4] CRANE, THE SOPHISTICATED INVESTOR 67 (1959); N.Y. STOCK EXCHANGE, FACT BOOK 42 (1961). The turnover percentage was approximately 12 per cent in 1960 as compared to 37 per cent in 1936.

[5] See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 202 (1963).

[6] See 3 LOSS, SECURITIES REGULATION 1515-16 (2d ed. 1961).

[7] 56 Stat. 852 (1940), 15 U.S.C. § 80b-6 (1958).

[8] 68 Stat. 686 (1954), 15 U.S.C. § 77q (a) (1958) provides in part: "It shall be unlawful for any person . . . (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 (3) to engage in any transaction, practice, or course of business which operates . . . as a fraud or deceit upon the purchaser."

[9] 17 C.F.R. § 240.10b-5 (1949) provides in part: "It shall be unlawful for any person, directly or indirectly . . . a) To employ any device, scheme, or artifice to defraud. b) To make any untrue statement of a material fact . . . . c) To engage in any act, practice, or course of business which operates . . . as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

in subsequent legislation unless the context requires otherwise.[10] Neither Section 17(a) of the Securities Act of 1933 nor rule 10b-5 is limited to the requirements of common-law deceit[11] and it is therefore unnecessary for the SEC, in order to procure an injunction under these provisions, to show express misrepresentation[12] or actual loss.[13] The acts, as thus construed, view the terms "fraud" and "deceit" as inclusive of conduct tending to deceive or mislead the purchasing public.[14]

The courts' reluctance to construe the securities acts as requiring proof of intent to injure and actual loss is illustrated by the case of *Norris & Hirshberg v. SEC*,[15] where the court stated:

> To say, as petitioner does, that every element of common-law fraud must be proven . . . is to say that Congress had no purpose in enacting regulatory statutes in this [securities] field and that its legislation in the field is meaningless. On the contrary, it has long been recognized . . . that the investing . . . public needs special protection in this specialized field.[16]

Although the statute, as interpreted, rejects the restrictive definition of common-law fraud, it retains the common-law concept of fiduciary duty as determinative of the adviser's duty to his client. That the relation is one of trust and confidence has been recognized numerous times under the securities acts,[17] and by the investment advisers themselves.[18] It is well settled that a party in a trust relation with another is under a duty to make a full disclosure of all material facts necessary to enable the other party

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[10] Case v. Los Angeles Lumber Co., 308 U.S. 106, 115 (1939); Keck v. United States, 172 U.S. 434, 446 (1899); 3 Loss, *op. cit. supra* note 6.

[11] Los Angeles Trust Deed & Mortgage Exch. v. SEC, 264 F.2d 199, 210 (9th Cir. 1959) (concerning § 17(a)); Speed v. Transamerica Corp., 99 F. Supp. 808, 831-32 (D. Del. 1955) (concerning rule 10b-5).

[12] Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944).

[13] Otis & Co. v. SEC, 106 F.2d 579, 582-83 (6th Cir. 1939). In 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), *reaff'd on remand*, 22 F. Supp. 602 (S.D.N.Y. 1938), the court held that "it is of no consequence that purchasers may have obtained full value for their money. . . . Persons may be deceived and yet suffer no financial loss."

[14] Hooper v. Mountain Sec. Corp., 282 F.2d 195 (5th Cir. 1960); Archer v. SEC, 133 F.2d 795 (8th Cir.), *cert. denied*, 319 U.S. 767 (1943). See generally Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933).

[15] 177 F.2d 228 (D.C. Cir. 1949).

[16] *Id.* at 233.

[17] Charles Hughes & Co. v. SEC, *supra* note 12; SEC v. Torr, *supra* note 13; see 2 Loss, SECURITIES REGULATION 1412 (2d ed. 1961).

[18] *Hearings on S. 3580 Before Subcommittee of the Senate Committee on Banking and Currency*, 76th Cong., 3d Sess. 719 (1941).

to determine whether he should act upon the fiduciary's advice.[19] An adviser's failure to disclose the fact that he has taken a position in a stock is apparently regarded as improper by the securities industry itself.[20] In addition to the attitude of the business community, the congressional reports on securities legislation indicate that the fundamental purpose of such legislation is the protection of investors.[21] This protection was accomplished by substituting the doctrines of "let the seller beware"[22] and full disclosure for the ancient doctrine of *caveat emptor,* in an effort to achieve a high standard of ethics in the securities industry.

SEC v. Torr,[23] a case arising under Section 17(a) of the Securities Act of 1933, is an example of both the liberal construction of "fraud" and an adviser's duty to disclose. In *Torr,* defendant advisers had been promised commissions for every sale of a security attributable to their influence.[24] The court held that despite defendants' good faith belief[25] in the propriety of the investment, their failure to disclose their position and interest in the stock recommended operated as an imposition and deceit on purchasers.[26] The court commented that the preliminary injunction restraining the defendants from further violation would have been granted even if none of defendants' clients had suffered financially.[27]

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[19] Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928); PROSSER, TORTS 534-35 (2d ed. 1955).

[20] See 2 NEW YORK STOCK EXCHANGE GUIDE ¶ 2474 A. 10 (1958), recommending that advisers disclose their interest.

[21] S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933); see S. REP. No. 1775, 76th Cong., 3d Sess. 21 (1940): "The nature of the functions of the investment advisers, their increasing widespread activities, their potential influence on security markets and the dangerous potentialities of stock market tipsters imposing upon unsophisticated investors, convinces this committee that protection of investors requires the regulation of investment advisers on a national scale."

[22] H.R. REP. No. 85, 73d Cong., 1st Sess. 2 (1933).

[23] *Supra* note 13.

[24] The effect of advisers' recommendations is clearly shown by this case where trading in the recommended stock rose from 400 shares daily to 2,400 shares daily with an accompanying price increase from three to four and three-eighths dollars. SEC v. Torr, *supra* note 13, at 316-17.

[25] Even before the securities acts it had been held that an adviser's belief in the soundness of his advice was immaterial. Ridgely v. Keene, 134 App. Div. 647, 119 N.Y. Supp. 451 (2d Dep't 1909). "The law takes into account human frailty, and absolutely forbids the assumption of conflicting obligations and duties. . . ." *Id.* at 649, 119 N.Y. Supp. at 452.

[26] On the existence of a duty to disclose, see 3 RESTATEMENT, TORTS § 551(2) (1938).

[27] Hughes v. SEC, 174 F.2d 968, 974-75 (D.C. Cir. 1949). The court held that the adviser's position as fiduciary required the disclosure of "every element of adverse interest" and that violations of the anti-fraud provisions would be made out even if all of the adviser's clients had profited by the advice.

In the principal case Mr. Justice Goldberg, writing for the majority, stated that the terms "fraud" and "deceit" were used "remedially" and not "technically" in the Act and that Congress "did not intend to require proof of intent to injure and actual injury to the client." [28] To require the SEC to show deliberate dishonesty would "effectively nullify the protective purpose of the statute." [29] Recognizing the defendant's position as one of trust and confidence, the Court stated that he was required to make a full disclosure of his personal interest in a recommendation, regardless of his belief in its propriety.[30] Failure to disclose was held to be "fraud" or "deceit" within its intended meaning in the Act. The defendant's argument against this conclusion, on the ground that failure to disclose material facts had not been made specifically unlawful by the Act, as it had by the Securities Act of 1933,[31] was considered and rebutted by the Court. Citing case law, which has uniformly treated non-disclosure as one variety of "fraud" or "deceit," [32] and to the purpose and philosophy of the Act, the Court concluded that Congress must have "deemed a specific proscription against non-disclosure surplusage." [33]

Mr. Justice Harlan, in his dissenting opinion, expressed the belief that "the nondisclosed facts indicate no more than that the respondents [defendants] personally profited from the foreseeable reaction to sound and impartial investment advice." [34] He asserted that there was no proof that the recommendations were based upon anything other than a belief in the soundness of the advice,[35] and further, that there was nothing in the Act's legislative history which "lends support to the absolute rule of disclosure" pronounced by the majority.[36]

In the light of its background, the Court's decision in the principal case is not surprising, but rather, a logical step in the

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[28] SEC v. Capital Gains Research Bureau, Inc., *supra* note 5, at 195. The practicality of such a holding is clear since proof of damages is particularly difficult in the securities area. 1 HARPER & JAMES, TORTS 597 (1956). For a discussion of the problems involved in the valuation of securities, see Note, 37 COLUM. L. REV. 134 (1937).

[29] SEC v. Capital Gains Research Bureau, Inc., *supra* note 5, at 200.

[30] "The Investment Advisers Act of 1940 'was directed not only at dishonor, but also at conduct that tempts to dishonor.'" United States v. Mississippi Generating Co., 364 U.S. 520, 549 (1961).

[31] The specific provision omitted from the Investment Advisers Act of 1940 is subdivision 2, of Section 17(a) of the Securities Exchange Act of 1933 which provides: "It shall be unlawful . . . (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact. . . ." 48 Stat. 84 (1933).

[32] See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 198 n.52 (1963).

[33] *Id.* at 199.

[34] *Id.* at 203-04.

[35] *Id.* at 204.

[36] *Id.* at 206.

expansive interpretation of securities legislation. The subscriber is paying for an adviser's disinterested advice, which advice he assumes is given in his best interest. If an adviser is himself a beneficial owner, his interest is at least potentially adverse to his client's right to receive objective, unbiased advice. The requirement of disclosure is clearly more practical than absolutely prohibiting an adviser from taking a position in a recommended security.[37] However, the use of an injunction to compel compliance with the Act seems severe when its effect on an adviser's reputation is considered.[38] Furthermore, since an injunction is directed to an individual and not to a practice, it provides a partial solution at best.

The practical alternative to injunction proceedings is provided by the 1960 amendments to the Act, empowering the SEC to define and prescribe rules to prevent "fraudulent, deceptive, or manipulative" practices.[39] Under this provision, which received little attention in the principal case, the Commission is empowered to promulgate rules which will give notice to the industry of the practices regarded by it as proper and improper.[40] As a result, the possibility that injustice will be done will be minimized. At least one thing is clear; armed with the liberal interpretation given "fraud" in the principal case and its new rule-making power, the SEC will undoubtedly be taking a more active role in the regulation of investment advisers.

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[37] The adviser might want to legitimately purchase a security which he plans to recommend so that his clients can purchase from his inventory at a price which will not be inflated by the market's reaction to the recommendation.

[38] Since an adviser's success depends, for the most part, on his reputation, the finding of "fraudulent practice" in a judicial proceeding is likely to irreparably injure his business although he may have had no unlawful or fraudulent intent.

[39] Investment Advisers Act § 206, 54 Stat. 852 (1940), 15 U.S.C. § 80b-6 (Supp. IV, 1963). In S. Rep. No. 1760, 86th Cong., 2d Sess. 8 (1960), it was stated that "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." Although two of the violations involved in the principal case took place after the effective date of this amendment, it was not relied upon by the SEC.

[40] The Commission has already issued three regulations pursuant to its rule-making power. 17 C.F.R. § 275.204-2 (Supp. 1962) (requiring that extensive records be kept); 17 C.F.R. § 275.206 (4)-1 (Supp. 1962) (dealing with advertising practices); 27 Fed. Reg. 2150 (1962) (concerning the adviser's possession of his client's funds or securities).