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# Securities Regulation - Investment Adviser Compelled to Disclose Potential Conflict of Interests

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as of the year of the first exploration expenditures,<sup>59</sup> but the 1964 Revenue Act provisions permit the taxpayer to wait until the first year in which a development or operational expenditure is made.<sup>60</sup> Generally, the first type of expenditure to necessitate an election under the new rules will be intangible drilling and development costs. Therefore, the new rules provide the taxpayer with more time to make an election than was provided under the 1939 Code rules.

The apparent intent of Congress is to eliminate the effect of the broad treatment of the 1954 Code by returning to the lease concept of aggregation of mineral interests as the general rule for determining the property unit for depletion purposes. The rules established by the Revenue Act of 1964 appear to have accomplished this purpose. The new rules also appear to establish a more consistent approach to oil and gas taxation in that they have eliminated a major source of administrative friction.<sup>61</sup> In addition, the new provisions should result in a more practical business approach to the problem of depletion, although the industry seemed to have adjusted to the operating unit concept without too much difficulty.

Even though the rules appear to have reduced certain tax-saving opportunities stemming from aggregations, they do permit a rather substantial amount of tax planning through a careful combination and separation of property interests within each tract; and it appears that a careful analysis of the particular problems involved will continue to pay dividends in the depletion area.

*John W. Bickle*

## Securities Regulation—Investment Adviser Compelled To Disclose Potential Conflict of Interests

### I. THE COMMON LAW REMEDY

The classical common law formula for fraud and deceit required: (1) a false representation of a material fact, (2) the defendant must know of the falsity (*scienter*) and make the statement for the pur-

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<sup>59</sup> G.C.M. 22106, 1941-1 Cum. Bull. 245, modified by G.C.M. 24094, 1944-1 Cum. Bull. 250.

<sup>60</sup> Int. Rev. Code of 1954, § 614(b)(4), as amended, 78 Stat. 94 (1964).

<sup>61</sup> Although the operating unit concept of aggregations was in many situations advantageous, it was administratively cumbersome to deal with and had become a prime area for negotiation and compromise from a practical standpoint between the taxpayer and the Internal Revenue Service. This problem is discussed in Staff of Joint Economic Comm., 88th Cong., 2d Sess., *The Federal Tax System: Facts and Problems 1964*, 107-18 (1964).

pose of inducing the plaintiff to rely on it, (3) the plaintiff must justifiably rely on it and (4) suffer damages as a consequence. The relief commonly sought at law between parties to an arm's length transaction will normally be awarded only if *all* of the above elements are found to be present.<sup>1</sup> The content of common law fraud and deceit, however, has not remained static, but has varied with the nature of the relief sought, the relationship of the parties and the merchandise in issue.<sup>2</sup>

## II. MODIFICATION OF COMMON LAW REMEDY BY SECURITIES LEGISLATION

The common law concept of fraud and deceit, technically construed, proved to be ill adapted to the regulation of securities and to the protection of the investing public.<sup>3</sup> This inadequacy, combined with the abuses which contributed to the market crash of 1929 and the depression of the 1930's, resulted in the passage of the six securities-regulation acts.<sup>4</sup> The first was the Securities Act of 1933.<sup>5</sup> Congress was prompted to initiate this legislation by a Presidential message requesting that the ancient rule of "caveat emptor" be superseded by a policy of full disclosure in the securities field.<sup>6</sup> The general antifraud provision of this act<sup>7</sup> makes unlawful any form of

<sup>1</sup> "Without the concurrence of all of these elements there can be no actionable fraud. None can be presumed, but each must be strictly proved, and the burden is on the plaintiff to establish the fraud by clear, convincing and satisfactory evidence." *Equitable Life Ins. Co. v. Halsey, Stuart & Co.*, 112 F.2d 302, 308 (7th Cir. 1940), *rev'd on other grounds*, 312 U.S. 410 (1941).

<sup>2</sup> See generally Shulman, *Civil Liability and the Securities Act*, 43 Yale L.J. 227 (1933).

<sup>3</sup> *Ibid.*

<sup>4</sup> (1) Investment Advisers Act of 1940, 54 Stat. 847, as amended, 15 U.S.C. §§ 80b-1-21 (1958).

(2) Investment Company Act of 1940, 54 Stat. 789, as amended, 15 U.S.C. §§ 80a-1-52 (1958).

(3) Trust Indenture Act of 1939, 53 Stat. 1149, as amended, 15 U.S.C. §§ 77aaa-77bbbb (1958).

(4) Public Utility Holding Company Act of 1935, 49 Stat. 838, as amended, 15 U.S.C. §§ 79-79z-6 (1958).

(5) Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. §§ 78a-78jj (1958).

(6) Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. §§ 77a-77aa (1958).

<sup>5</sup> 48 Stat. 74, as amended, 15 U.S.C. §§ 77a-77aa (1958).

<sup>6</sup> H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933).

<sup>7</sup> 48 Stat. 84, as amended, 15 U.S.C. § 77q provides:

(a) 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 or deceit upon the purchaser.

fraud, untruth or omission of a material fact, with respect to the sale of any securities in interstate commerce or by use of the mails. The act provides civil<sup>8</sup> as well as governmental sanctions for fraud.

The second act, the Securities Exchange Act of 1934,<sup>9</sup> extended the scope of disclosure required in dealing with securities listed on national securities exchanges. Rather than regulating offers of securities by the issuing company, this act regulates transactions in outstanding securities. This act created the Securities Exchange Commission and gave it responsibility for providing rules and regulations to implement the general regulatory pattern of the act. Among the regulations adopted by the Commission are the definition of acts or practices which constitute a "manipulative or deceptive device or contrivance"<sup>10</sup> prohibited by the antifraud provisions of the statute.<sup>11</sup>

The Investment Advisers Act of 1940, the last act in the field of securities regulation, also contained antifraud provisions.<sup>12</sup> This act

<sup>8</sup> The 1934 act contains three specific civil liability sections: §§ 9(e), 16(b), and 18. Cases which have asserted civil liability under this act include: *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Rosenberg v. Hano*, 121 F.2d 818 (3d Cir. 1941); *Geismar v. Bond & Goodwin, Inc.*, 40 F. Supp. 876 (S.D.N.Y. 1961); *Stella v. Kaiser*, 82 F. Supp. 301 (S.D.N.Y. 1948); *Acker v. Schulte*, 74 F. Supp. 683 (S.D.N.Y. 1947); *Bach v. Quigan*, 5 F.R.D. 34 (E.D.N.Y. 1945). For numerous cases involving the recapture from insiders of short-term trading profits under § 16(b), see 2 Loss, *Securities Regulation* 1040 (2d ed. 1961).

<sup>9</sup> 48 Stat. 881, as amended, 15 U.S.C. §§ 78a-78jj (1958).

<sup>10</sup> This regulation is identical to § 78i(a)(2) of the Securities Exchange Act of 1934. 48 Stat. 889, as amended, 15 U.S.C. § 78i(a)(2) (1958).

<sup>11</sup> 48 Stat. 891, as amended, 15 U.S.C. § 78j (1958), provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

<sup>12</sup> 54 Stat. 852 (1940), as amended, 15 U.S.C. § 80b-6 (Supp. V, 1964), provides:

It shall be unlawful for any investment adviser, 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;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(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

makes it unlawful for registered investment advisers<sup>13</sup> to engage in practices which constitute fraud or deceit, requires that they disclose any interest in transactions executed for their clients, prohibits profit-sharing arrangements and effectively prevents the assignment of investment advisory contracts without the client's consent.

These acts were designed to promote a high standard of business ethics in the securities industry by requiring, among other things, full disclosure of anything material to the interests of the investing public. In the spirit of this legislation, the courts have recognized that the "essential objective of securities legislation is to protect those who do not know market conditions from the overreaching of those who do."<sup>14</sup> Recognizing the presence of a gross inequality of knowledge between the professional securities firm or adviser and the average investor, the courts have held that the fraud provisions in the Securities Act of 1933<sup>15</sup> and the Securities Exchange Act of 1934<sup>16</sup> are not limited to circumstances which give rise to a common law action for deceit.<sup>17</sup> In *SEC v. Torr*,<sup>18</sup> nondisclosure by a broker-dealer was held to be a violation of the antifraud provisions of both the 1933 and 1934 securities acts.<sup>19</sup> The defendants recommended the purchase of stocks without disclosing to their clients that they were to receive bonuses for any sales of this stock attributable to their influence.<sup>20</sup> There was nothing to indicate that the defendants mis-

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reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

The other three securities acts, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939 and the Investment Company Act of 1940, though requiring disclosure of adverse interests, do not contain antifraud provisions per se; and due to their restricted application, they will not be treated in this note.

<sup>13</sup> The act defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . ." Certain exceptions are made to this definition, including broker-dealers who are covered by the Securities Exchange Act of 1934. Investment Advisers Act of 1940, 54 Stat. 847, as amended, 15 U.S.C. § 80b-2(11) (1958).

<sup>14</sup> *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944).

<sup>15</sup> See note 7 *supra*.

<sup>16</sup> See note 11 *supra*.

<sup>17</sup> *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961); *Norris & Hirshberg, Inc. v. SEC*, 177 F.2d 228 (D.C. Cir. 1949); *Arleen Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949); *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 (8th Cir. 1943), *cert. denied*, 319 U.S. 767 (1943); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951); *SEC v. Torr*, 15 F. Supp. 315 (S.D.N.Y. 1936), *rev'd on other grounds*, 87 F.2d 446 (2d Cir. 1937).

<sup>18</sup> 15 F. Supp. 315 (S.D.N.Y. 1936), *rev'd on other grounds*, 87 F.2d 446 (2d Cir. 1937).

<sup>19</sup> The securities acts of 1933-34 cover nondisclosure by *brokers and dealers*. It was not until the Investment Advisers Act of 1940 that coverage was extended to persons dealing solely in investment advice.

<sup>20</sup> The effect of advisers' recommendations is clearly shown by this case. Trading in

represented any fact bearing on the intrinsic worth of the recommended stock. The court held that despite defendants' good faith belief in the propriety of the investment,<sup>21</sup> failure to disclose their interest in the recommended stock violated the statutes. The court commented that the preliminary injunction restraining the defendants from further violations would have been granted even if none of the defendants' clients had suffered financially.<sup>22</sup> In *Arleen Hughes v. SEC*,<sup>23</sup> the court held that the broker's position as a fiduciary required the disclosure of every element of adverse interest and that violations of the antifraud provisions could occur even if all of the broker's clients had *profited* by the advice. The reluctance on the part of the courts to construe the securities acts as requiring proof of intent to injure and actual loss is illustrated by the case of *Norris & Hirschberg v. SEC*, in which 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 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.<sup>24</sup> (Emphasis added.)

*Charles Hughes & Co. v. SEC*,<sup>25</sup> "one of the great cases under the SEC statutes,"<sup>26</sup> likewise stated that the court "need not stop to decide . . . how far common-law fraud was shown. For the business of selling investment securities has been considered one peculiarly in need of regulation for the protection of the investor."<sup>27</sup> This case revoked the registration of a broker-dealer firm for violating the antifraud provisions of the act of 1933 and the act of 1934 by soliciting customers and selling them securities at prices far above market value.<sup>28</sup>

The fiduciary duty owed to the public by individuals covered by the antifraud provisions of the 1933-34 acts was recognized in *Charles Hughes* and succeeding cases and is sometimes termed the

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the stock recommended rose from 400 shares daily to 2,400 shares daily with an accompanying per share price increase from \$3 to \$4 $\frac{3}{8}$ . *SEC v. Torr*, 15 F. Supp. 315, 316 (S.D.N.Y. 1936).

<sup>21</sup> 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 (1909). "The law takes into account human frailty and absolutely forbids the assumption of conflicting obligations and duties . . ." *Id.* at 453.

<sup>22</sup> *SEC v. Torr*, 15 F. Supp. 315, 317 (S.D.N.Y. 1936).

<sup>23</sup> 174 F.2d 969 (D.C. Cir. 1949).

<sup>24</sup> 177 F.2d 228, 233 (D.C. Cir. 1949).

<sup>25</sup> 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944).

<sup>26</sup> 3 Loss, Securities Regulation 1484 (2d ed. 1961).

<sup>27</sup> 139 F.2d at 437.

<sup>28</sup> The prices which customers paid for the securities purchased ranged from 16.1% to 40.9% above market value. *Id.* at 436.

"shingle theory."<sup>29</sup> The major premise of the "shingle theory" is that the securities dealer impliedly represents, by the act of hanging out his shingle, that he will deal fairly with the public. As applied in the *Charles Hughes* case, a broker-dealer charging a price that does not bear some reasonable relation to the current market, unless that fact is disclosed, has breached this implied representation, thus perpetrating a fraud on the customer.

### III. SEC V. CAPITAL GAINS RESEARCH BUREAU, INC.<sup>30</sup>

The Supreme Court, in the first case to construe the antifraud provisions of the Investment Advisers Act, or apparently any of the other securities acts, has remedially construed the antifraud provisions to complement corresponding provisions in the earlier acts as interpreted by lower courts. Capital Gains Research Bureau published two investment advisory services,<sup>31</sup> one of which—*A Capital Gains Report*—recommended certain securities for long term holding.<sup>32</sup> On six different occasions Capital Gains Research Bureau took a position in a particular stock shortly before recommending that its subscribers purchase or sell the same stock.<sup>33</sup> On the increased trading volume<sup>34</sup>

<sup>29</sup> See generally 3 Loss, Securities Regulation 1482 (2d ed. 1961).

<sup>30</sup> 375 U.S. 180 (1963).

<sup>31</sup> Capital Gains published two bulletins which it distributed to subscribers. One, entitled *Facts on Funds*, explored changes in the portfolio of mutual funds; the other, *A Capital Gains Report*, was a regular service which periodically evaluated securities. There were about 20,000 subscribers to the *Facts on Funds* bulletin, and about 5,000 subscribers to *A Capital Gains Report*, with some 100,000 copies of the latter publication being frequently distributed to nonsubscribers. SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606, 612 (2d Cir. 1962).

<sup>32</sup> *A Capital Gains Report* is described as: "an investment service devoted exclusively to (1) the protection of investment capital, (2) the realization of a steady and attractive income therefrom, (3) the accumulation of capital gains thru the timely purchase of corporate equities that are proved to be undervalued." *Ibid.*

<sup>33</sup> Capital Gains purchased stock in five corporations and purchased call options in a sixth shortly before recommending that its subscribers take a long position, and purchased eleven three-month puts and sold short 500 shares in the seventh corporation just prior to suggesting that this corporation was overvalued. The positions were taken by Capital Gains from three to fourteen days in advance of its recommendations; they were liquidated seven to fourteen days following the recommendations. A profit of \$19,674.00 was realized.

<sup>34</sup> VOLUME OF SHARES TRADED

	2d Day Before Report	1st Day Before Report	Day of Report	1st Day After Report	2d Day After Report	3d Day After Report
Continental Ins. Co.	6,400	3,200	3,100	9,000	12,200	6,000
United Fruit Co.	4,600	6,400	6,100	15,200	12,700	14,700
Creole Petroleum Corp	5,000	6,700	3,300	10,300	4,500	5,700
Hart, Schaffner & Marx	100	500	1,800	2,800	1,600	1,200
Union Pac. R.R.	7,500	5,800	5,200	15,100	17,600	19,900
Chock Full O'Nuts Corp.	1,900	1,500	1,100	2,500	1,000	900

Brief for Appellant, pp. 15-20, SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606 (2d Cir. 1962). See also Note, 51 Calif. L. Rev. 232, 234 (1963). As indicated by the chart, in each instance the report had a substantial impact on the volume of shares traded for each individual stock.

and predictable price movement occasioned by the report, Capital Gains Research Bureau would liquidate its position, taking a profit. Such practice is commonly known as "scalping."<sup>35</sup> The Securities and Exchange Commission sought a preliminary injunction<sup>36</sup> under section 206 (1) and (2) of the Investment Advisers Act<sup>37</sup> to require Capital Gains Research Bureau to disclose any potential conflict of interest in its recommendation of a particular security. The antifraud provisions enable a court to enjoin any practice which operates "as a fraud or deceit upon any client or prospective client."<sup>38</sup> The trial court,<sup>39</sup> affirmed by the court of appeals,<sup>40</sup> denied the injunction because *no actual injury* or *intent to cause such injury* to a client was alleged or proved. On certiorari the United States Supreme Court reversed the judgment of the court of appeals and remanded the case to the district court. The Court rejected a technical construction of the act<sup>41</sup> and applied a broad remedial interpretation which encompassed nondisclosure of material facts. The Court traced the common law development of fraud and deceit, recognized the modifications thereof as applied to securities regulation and interpreted the study and report<sup>42</sup> which culminated in the Investment Advisers Act to proscribe just such activity as that carried on by Capital Gains Research Bureau. Justification for this position was aided by language

<sup>35</sup> Judge Clark termed "scalping" as the practice known on Wall Street "by which an investment adviser makes a short-term profit on the direct or secondary market reaction to its advice." *SEC v. Capital Gains Research Bureau, Inc.*, 306 F.2d 606, 613 (1962).

<sup>36</sup> Under authority of § 209(e) of the Investment Advisers Act of 1940, 54 Stat. 853, 15 U.S.C. § 80b-9(e) (1958) which authorizes the injunctive remedy. The injunction would have required Capital Gains in any future report to disclose the material facts concerning any purchase of recommended securities "'within a very short period prior to the distribution of a recommendation . . .,' and 'the intent to sell and the sale of said securities . . . within a very short period after distribution of said recommendation. . . .'" *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 183 (1963).

<sup>37</sup> The section of the act is quoted in note 12 *supra*. It should be noted that the SEC did not rely on subsections (3) and (4) which were added in 1960 to strengthen the fraud provisions of the act.

<sup>38</sup> 54 Stat. 852 (1940), as amended, 15 U.S.C. § 80b-6(2) (Supp. V, 1964).

<sup>39</sup> 191 F. Supp. 897 (S.D.N.Y. 1961).

<sup>40</sup> 306 F.2d 606 (2d Cir. 1962).

<sup>41</sup> The courts below had looked to language of the 86th Congress (which was considering legislation that led to the 1960 amendment to the Investment Advisers Act) for determining the meaning of the antifraud provisions. 306 F.2d at 610. It was there expressed that doubt existed "as to the scope of the fraudulent and deceptive activities that are prohibited and as to how far it is limited in this area by common law concepts of fraud and deceit." *Hearings on S. 1176 Before a Subcommittee of the Senate Committee on Banking and Currency*, 86th Cong., 1st Sess. 516 (1959).

The Supreme Court, unlike the courts below, looked to the legislative history of the 1940 act rather than to that of the 1960 amendment to determine Congressional intent. The Court embraced Judge Clark's dissent in the court of appeals in which he stated that "the opinions attributed to a Congress twenty years after the event cannot be considered evidence of the intent of the Congress of 1940." 306 F.2d at 615.

<sup>42</sup> SEC, *Report on Investment Trusts and Investment Companies Pursuant to Section 30 of the Public Utility Holding Company Act of 1935*, H.R. Doc. No. 447, 76th Cong., 2d Sess. 1 (1940).



of the Seventy-sixth Congress which recognized the fiduciary relationship of an investment adviser.<sup>43</sup> Moreover, the Supreme Court in the instant case held that "it would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold . . . that Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit,' intended to require proof of intent to injure and actual injury to clients."<sup>44</sup> In so stating, the Court once again rejected the application of technical principles of common law deceit to the securities field. This view would seem to find ample support in the hearings<sup>45</sup> conducted in conjunction with the enactment of the Investment Advisers Act and is certainly in keeping with the judicial interpretation of the antifraud provisions of the securities acts of 1933-34.<sup>46</sup>

#### IV. CONCLUSION

The effect of *Capital Gains* is to require of investment advisers the same full disclosure of all material facts as required under the other five acts regulating the securities industry.<sup>47</sup> Enforcement of the Investment Advisers Act is available without proof of all four elements of common law deceit.<sup>48</sup> As in the line of cases granting civil remedies under the prior securities acts,<sup>49</sup> it is quite probable that a civil remedy would likewise be available under the Investment Advisers Act of 1940.<sup>50</sup> The problem of proving damages, however, would be extremely difficult.

<sup>43</sup> "The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963) (citing 2 Loss, Securities Regulation 1412 (2d ed. 1961)).

<sup>44</sup> 375 U.S. at 192.

<sup>45</sup> *Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency*, 76th Cong., 2d Sess. (1940); *Hearings on H.R. 10065 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 76th Cong., 2d Sess. (1940).

<sup>46</sup> See cases cited in notes 18, 23, 24 and 25 *supra* and accompanying text.

<sup>47</sup> Perhaps an analogy can be drawn between the prohibition against an insider taking a profit on the "short-swing," and the investment adviser engaging in "scalping." Both the insider and the investment adviser are acting upon the predictable market effect of the knowledge they possess in advance of that possessed by the investing public. For interpretation of the duty owed by an insider, see generally Cady, Roberts & Co., 40 S.E.C. 907 (1961).

<sup>48</sup> Loss states, in writing about the elements of proof required with regard to the securities laws: "It is obvious . . . that some of the basic problems are the same [common law problems and securities law problems]—what is false, what is fact, what is material. Because of the legislative background it seems reasonable to assume at the very least that the most liberal common law views on these questions should govern under the statutes." 3 Loss, Securities Regulation 1435 (2d ed. 1961).

<sup>49</sup> See note 8 *supra*.

<sup>50</sup> "The only relevant provision of this statute is § 215(b), which is comparable (but not identical) with the 'voiding' provision in § 29(b) of the Exchange Act. There has been no litigation." 3 Loss, *op. cit. supra* note 48, at 1746.

The court in *Capital Gains* applies the premise of the "shingle theory" as fully to the investment advisory services as to any other phase of the securities business.<sup>51</sup> When the adviser "hangs out his shingle," he impliedly represents that he will deal fairly with the public.<sup>52</sup> To deal fairly with the public, the investment adviser should "continuously occupy an impartial and disinterested position, as free as humanly possible from the subtle influence of prejudice, conscious or unconscious; he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect."<sup>53</sup> His compensation for investment advice "should consist exclusively of direct charges to clients for services rendered."<sup>54</sup>

Presumably, the investment adviser will achieve full compliance with the dictates of the act only if *full* disclosure is made of any potential conflict of interest.<sup>55</sup> Logically, the time and method of disclosure would seem best suited to the *same* report in which a purchase or sale of the stock is recommended to the investor. Such disclosure will permit the investor to make a fair evaluation of the advice given and will also protect the adviser from possible liability based on a breach of fiduciary responsibility.<sup>56</sup>

The court in *Capital Gains* makes clear that nondisclosure is to be enjoined, but the degree of disclosure required is not elucidated. Although vested with such power by virtue of section 206(4) of the Investment Advisers Act (1960 amendment to the act),<sup>57</sup> the

<sup>51</sup> The "shingle theory," though ordinarily based on an implied representation of pricing reasonably related to the market, finds application in other phases of the securities industry. Loss states that "it is likewise an incident of the representation of fair dealing that the dealer will disclose any substantial long or short position or other bias which may affect his recommendations." 3 Loss, *op. cit. supra* note 48, at 1489.

<sup>52</sup> Note 29 *supra* and accompanying text.

<sup>53</sup> SEC, *Report on Investment Trusts and Investment Companies*, *supra* note 42, at 66-67.

<sup>54</sup> *Id.* at 66.

<sup>55</sup> It is understood to be the administrative construction . . . that one incident of this duty [the duty the agent always has to disclose to his principal all facts "which he should realize have or are likely to have a bearing upon the desirability of the transaction from the viewpoint of the principal,"] is that a broker or investment adviser who solicits or recommends purchases or sales must disclose the existence (though not necessarily the amount) of any long or short position of the firm, or any partner, officer, director or member of their immediate families, or any employee assuming responsibility for the recommendation, if the position is substantial in relation to the total resources and holdings of the firm or any such individual. 3 Loss, *op. cit. supra* note 48, at 1503-04.

<sup>56</sup> "An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate such overlapping motivations, *through appropriate disclosure*, in deciding whether an adviser is serving 'two masters' or only one, 'especially . . . if one of the masters happens to be economic self-interest.'" SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 196 (1963). (Emphasis added.)

<sup>57</sup> 74 Stat. 887 (1960), 15 U.S.C. § 80b-6(4) (Supp. V, 1964) provides: "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."