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Securities Regulation -- "Fraud" to Include Nondisclosure

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old doctrines and distinctions are simply not adequate to meet the needs of the changing technology of the building industry and the corresponding needs of purchasers. A realistic appraisal will reveal that the doctrine of implied warranty offers a solution to a growing problem.

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Securities Regulation—"Fraud" to Include Nondisclosure

Section 206 of the Investment Advisers Act of 1940 makes it unlawful for an investment adviser, by the use of the mails or facilities of interstate commerce, "(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 . . . ."[1] Section 209(e) of the Act gives the Securities and Exchange Commission the power to bring an action for injunction, and the district courts power to enjoin such activities, when it has been shown that "any person has engaged, is engaged, or is about to engage in any act or practice constituting a violation of . . . [such] provision . . . ."[2]

Because of the general language of the antifraud provision quoted above, it was not known what fraudulent and deceptive activities were prohibited by this act or to what extent the Commission was limited in this area by common law concepts of fraud and deceit,[3] which would include proof of: (1) false representation of a material fact; (2) an intent to induce reliance; (3) actual reliance on the false representation; and (4) damage suffered as a result.[4]

The meaning of the statute was clarified in the recent case of *SEC v. Capital Gains Research Bureau, Inc.*[5] The Commission sought to obtain a preliminary injunction under section 206 to compel an investment advisory service and its president to disclose to

the ground that the system was a fixture and therefore governed by the applicable realty laws.

[1] Investment Advisers Act of 1940, §§ 206(1)-(2), 54 Stat. 852, as amended, 15 U.S.C. §§ 80b-6(1)-(2) (Supp. IV 1963).

[2] Investment Advisers Act of 1940, § 209(e), 54 Stat. 853, as amended, 15 U.S.C. § 80b-9(e) (Supp. IV 1963).

[3] S. REP. No. 1760, 86th Cong., 2d Sess. 8 (1960); H. REP. No. 2179, 86th Cong., 2d Sess. 7 (1960).

[4] 3 LOSS, SECURITIES REGULATION 1430 (2d ed. 1961); S. REP. No. 1760, 86th Cong., 2d Sess. 8 (1960).

[5] 375 U.S. 180 (1963).

their clients a practice of buying securities just before advising their purchase, and then selling them at a profit upon the price rise following the recommendation—commonly called "scalping." There was no evidence in the case that "any misstatements or false figures were contained in any of the bulletins," or that "the investment advice was unsound," or that "the defendants were being bribed to tout a stock contrary to their beliefs," or that "these bulletins were a scheme to get rid of worthless stock."[6] Instead, the case was premised wholly upon the fact that shortly before recommending them to their clients, the defendants purchased shares of certain securities; that following publication of the recommendations, there were small rises in the market price of each of the stocks; that the defendants then sold at a profit the shares previously purchased. In one instance the defendants sold short[7] shares of stock before commenting unfavorably about that security, and then covered their short position at a profit upon the resulting drop in market price.

The Second Circuit Court of Appeals ruled that "scalping" without disclosure to clients did not operate as a fraud or deceit upon any client within the meaning of the act, since there was no showing of intent to injure clients or actual injury to them.[8] That is, "fraud" was interpreted strictly, requiring intent to injure and actual injury, both elements of common law fraud.

In reversing, the Supreme Court said that the defendants' activities created a potential conflict of interest, and held that the Commission could get the injunction because "failure to disclose material facts must be deemed fraud or deceit . . . ."[9] The Court reviewed the history of the SEC acts and concluded that Congress passed them with their antifraud provisions because the common law remedies for fraud and deceit were ill-suited to be applied to securities transactions, due to the intangible nature of securities.[10] To effect the remedial purposes of the provisions, the Court said, they should be construed "not technically and restrictively, but flexi-

[6] *Id.* at 185.

[7] "The term 'short sale' means any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of the seller." SEC Rule 3b-3, 17 C.F.R. 240.3b-3 (1949).

[8] SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606 (2d Cir. 1962) (in banc), *rev'd*, 375 U.S. 180 (1963).

[9] 375 U.S. at 200.

[10] *Id.* at 194-95. See generally Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933).

bly. . . ."[11] The Court further said that one of the purposes of the acts was "to substitute a philosophy of disclosure for the philosophy of *caveat emptor*" and thus to achieve a high standard of business ethics in the securities industry.[12] As a result of the status created by the SEC acts, the Court reasoned, an investment adviser is a fiduciary and has a duty to disclose material facts to its clients; failure to make such disclosure operates as a fraud upon its clients, whether or not there is intent to injure or actual injury. The Court felt that such disclosure would tend to preserve the climate of fair dealing necessary to maintain public confidence in the securities industry and thus would be beneficial to the economy of the country.

Justice Harlan voiced the lone dissent[12a] maintaining that there was a lack of proof that the defendants' investment advice was not disinterested. It would seem, however, that "scalping" does create interests for an investment adviser which would be in conflict with those of his clients and which might influence his decisions in making recommendations to them. For example, he might be tempted to recommend a volatile stock which would respond more favorably to his recommendation than would a more solid stock. Another conflict of interests might arise if, after having bought the stock, but before having recommended it, he got unfavorable information regarding it, in light of which he would not have recommended it, had he not already taken a position in that security; in such a situation, he might be tempted to go ahead and recommend it anyway. A client might choose to follow the advice of an investment adviser despite the possibility of such a conflict of interest. Nonetheless, he should be given the information that a conflict does exist, so that he can choose whether or not to ignore it, rather than be left completely in the dark. It would seem that the majority reached the better result in saying that the fiduciary relationship between an investment adviser and his client requires disclosure in this situation, despite the absence of an explicit provision requiring disclosure.[12b]

Although Justice Harlan's dissent is not predicated upon lack of materiality, it conveys the impression that he felt the omissions in the case to be immaterial. Such an opinion would necessarily prevent him from agreeing with the majority. Since an investment adviser

[11] 375 U.S. at 195.
[12] 375 U.S. at 198.
[12a] 375 U.S. at 203.
[12b] 375 U.S. at 198.

cannot be required to disclose everything about every security he recommends, for practical reasons, his duty of disclosure must necessarily be limited only to those facts which are material, even under the most liberal reading of the act.

The principal case marks the first time that the Supreme Court has held failure to disclose a material fact to be fraud under any of the securities regulation acts. However, lower court and SEC decisions have interpreted antifraud provisions similar to those in the principal case to include such nondisclosure, although under facts perhaps more conducive to a finding that there was actual intent to defraud.[13] A brief look at some of these cases might shed light on the statutory interpretation in the principal case.

Charles Hughes & Co. v. SEC[14] involved sales of stock by customers' men at prices substantially above the over-the-counter price, without disclosing that the sale price was above the market price; there was conflicting testimony as to whether or not untrue statements had been made regarding the market price. In a petition to review an order which revoked the petitioner's registration as a broker and dealer, the Second Circuit Court of Appeals held that there need be no specific finding of whether or not the alleged statements had been made, since the failure to reveal the markup was both an omission to state a material fact and a fraudulent device, thus violating section 17(a) of the Securities Act of 1933.[15] The court said that the law of fraud knows no difference between express misrepresentation on the one hand and implied misrepresentation on the other.[16]

In another case, *Hughes v. SEC*,[17] the petitioner acted in a dual

[13] See, *e.g.*, Norris & Hirshberg v. SEC, 177 F.2d 228 (D.C. Cir. 1949); Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949); Archer v. SEC, 133 F.2d 795, *cert. denied*, 319 U.S. 767 (1943); Speed v. Transamerica Corp., 99 F. Supp. 808 (1951), *modified on other grounds*, 235 F.2d 369 (3d Cir. 1956).

[14] 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944).

[15] 48 Stat. 84, as amended, 15 U.S.C. § 77q(a) (1958), which provides: "(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any instruments or means of transportation 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."

[16] 139 F.2d at 437.

[17] 174 F.2d 969 (D.C. Cir. 1949).

capacity of investment adviser and of broker and dealer. In such capacity she sold her own shares to clients without fully disclosing such things as the best price at which such securities could be purchased in the open market and the cost to her of the securities sold to such clients. In sustaining the revocation of the petitioner's registration, the District of Columbia Court of Appeals relied on express language in the Securities Act making unlawful "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. . . ."[18] The court also said that the acts constituted violations of the antifraud sections of the 1933[19] and 1934[20] acts, and the regulations[21] thereunder, as well as saying that they were omissions to state facts necessary to clarify half-truths, which was expressly made unlawful.

A third case, *Speed v. Transamerica Corp.*,[22] involved a class action on behalf of minority shareholders against the majority shareholder of the corporation, charging that the defendant had fraudulently deprived them of their rightful participation in the liquidation of the corporation. The majority shareholder had offered to buy the shares of the minority shareholders without disclosing facts which indicated the value of the stock to be much greater than the price that the defendant offered to pay. In holding that the defendant violated Rule X-10B-5 concerning corporate "insiders,"[23] the district court said:

[18] Securities Act of 1933, § 17(a)(2), 48 Stat. 84, as amended, 15 U.S.C. § 77q(a)(2) (1958).

[19] Securities Act of 1933, § 17(a), 48 Stat. 84, as amended, 15 U.S.C. § 77q(a) (1958).

[20] Securities Exchange Act of 1934, § 10(b), 48 Stat. 891, 15 U.S.C. § 78j(b) (1958); § 15, as amended, 49 Stat. 1377 (1936), as amended, 15 U.S.C. § 780 (1958).

[21] Rule 10b-5, 17 C.F.R. § 240.10b-5 (1949); Rule 15c1-2, 17 C.F.R. § 240.15c1-2 (1949).

[22] 99 F. Supp. 808 (D. Del. 1951), *modified on other grounds*, 235 F.2d 369 (3d Cir. 1956).

[23] The rule, now denominated Rule 10b-5, declares it 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, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit 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 (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1949).

> Defendant's liability for non-disclosure is not based primarily upon the provision of subparagraph 2—subparagraph 1 of the Rule makes it unlawful "To employ any device, scheme, or artifice to defraud" and subparagraph 3 outlaws "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person...". The three subparagraphs of this broadly remedial rule are mutually supporting and not mutually exclusive as defendant contends. Defendant's breach of its duty of disclosure accordingly can be viewed as a violation of all three subparagraphs of the Rule, i.e., (1) a device, scheme, or artifice to defraud; (2) an implied misrepresentation or misleading omission; and (3) an act, practice, or course of business which operates or would operate as a fraud upon the plaintiffs.[24]

Although the above cases did not concern the provisions of the Investment Advisers Act, they did concern provisions which are almost identical to those in question.[25] As a matter of fact, the antifraud provisions of the Investment Advisers Act were modeled from subsections (1) and (3) of section 17(a) of the Securities Act,[26] the same section from which Rule 10b-5 was copied.[27] Thus the decisions interpreting the provisions of section 17(a) and Rule 10b-5 should be applied with equal force in interpreting section 206 of the 1940 act. It should be noted, however, that each of the cases involved partial nondisclosure, and not complete failure to disclose.

In 1962 the SEC imposed a penalty upon a stockbroker for nondisclosure when he traded for discretionary accounts on information concerning a dividend decrease received from a corporate insider who was his business associate. That is, liability was imposed under the antifraud provisions of Rule 10b-5 for mere nondisclosure. The decision, *In the Matter of Cady, Roberts & Co.*,[28] has been hailed as exemplifying a continuing expansion of the scope of liability under Rule 10b-5.[29]

Although section 206 has now been amended so that it apparently

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[24] 99 F. Supp. at 829.

[25] For the text of Rule 10b-5, see note 23 *supra*; for the text of section 17(a), see note 15 *supra*.

[26] 3 Loss, Securities Regulation 1515 (2d ed. 1961); SEC v. Capital Gains Research Bureau, Inc., 300 F.2d 745, 753 (1961), *aff'd on rehearing*, 306 F.2d 606 (2d Cir. 1962) (in banc), *rev'd*, 375 U.S. 180 (1963).

[27] Jennings & Marsh, Securities Regulation, Cases and Materials 793 (1963).

[28] SEC Securities Exchange Act Release No. 6668, Nov. 8, 1961.

[29] *E.g.*, Notes: 62 Colum. L. Rev. 735 (1962); 75 Harv. L. Rev. 1449 (1962); 48 Va. L. Rev. 398 (1962); 71 Yale L.J. 736 (1962).

covers "scalping,"[30] the nearly unanimous approval by the Supreme Court of the liberal interpretation of the provisions in this case should certainly have an impact upon securities regulation in the future. It should facilitate regulation of the industry, since broad legislation—intended to be interpreted broadly—can be enacted with reasonable assurance that its effect will not be unduly restricted by narrow interpretation.

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Torts—Independent Contractors—Duty of Care

In *Heldenfels v. Hernandez*[1] an employee of the owner of property on which construction work was being done brought action against a paving subcontractor for injuries sustained by the employee when struck by a backing truck. The jury found that the subcontractor failed to provide a flagman to warn the employee of the backing truck but found no affirmative negligence. The Texas court held that the plaintiff was merely a licensee as to the subcontractor and that it had breached no duty owed to the landowner's employee by its failure to provide a flagman. Even though the subcontractor owned no interest in the land, the court reasoned that it became an occupant of the private premises for the purpose of the construction work, and that although an occupier or owner of land may owe to a licensee the duty to warn him of *concealed* hazardous conditions, there is no duty to warn him of dangers on the land which are not concealed.

Owners and occupiers of land have been given immunities concerning the exercise of care which are not, as a general rule, available to others. It may be broadly stated that an owner or occupier has no duty of care toward a trespasser except the duty not to wilfully injure him.[2] He has a duty toward licensees which includes a duty to warn of concealed dangerous conditions of the premises of which

[30] Investment Advisers Act of 1940, § 206(4), added by § 9, 74 Stat. 887 (1960), 15 U.S.C. § 80b-6(4) (Supp. IV 1963).

[1] 366 S.W.2d 641 (Tex. Civ. App. 1963).

[2] Peters v. Bowman, 115 Cal. 345, 47 Pac. 113 (1896); Hooker v. Routt Realty Co., 102 Colo. 8, 76 P.2d 431 (1938); Previte v. Wanskuck Co., 80 R.I. 1, 90 A.2d 769 (1952). See generally 2 HARPER & JAMES, TORTS § 27.1 (1956) [hereinafter cited as HARPER & JAMES].