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Kentucky Law Journal

Volume 53 | Issue 1

Article 16

1964

Securities--Expanded Concept of Fraud--Investment Advisers Act of 1940

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Recommended Citation

Hollon, Leon L. (1964) "Securities--Expanded Concept of Fraud--Investment Advisers Act of 1940," *Kentucky Law Journal*: Vol. 53 : Iss. 1 , Article 16.

Available at: https://uknowledge.uky.edu/klj/vol53/iss1/16

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work in the county clerk's office and, if he had not contracted with the owner, give notice of his intention to claim a lien.[8] The third approach would be to file one notice in the county clerk's office pursuant to KRS 376.010(2) immediately after signing the subcontract. If the lien claimant had not contracted with the owner, he would then have up to seventy-five days after finishing his work on the last house to give notice as required by KRS 376.010(3).

James Avery Shuffett

SECURITIES—EXPANDED CONCEPT OF FRAUD—INVESTMENT ADVISERS ACT OF 1940.—The Securities and Exchange Commission brought this action against the defendant, a registered investment adviser. On several occasions defendant bought shares of stock for its own account. Shortly after each purchase it recommended the purchased security to clients for long term investments. Following a rise in the market price of the recommended security, defendant immediately sold its shares at a profit. The defendant failed to disclose these transactions to its clients. The Commission requested an injunction under the Investment Advisers Act of 1940[1] compelling defendant to disclose to its clients any dealings in recommended securities. The United States District Court of New York denied relief.[2] The United States Court of Appeals for the Second Circuit affirmed.[3] Certiorari was granted. *Held:* Reversed and remanded. The Commission may obtain an injunction compelling an investment adviser to disclose to clients

[8] True, the houses which had been conveyed and their deeds recorded would escape his lien, as this case so holds, but KRS 376.060 provides a remedy:

> If the owner of . . . land or improvements thereon contracts for . . . material used in the erection . . . of any structure thereon under such circumstances that a lien for the payment thereof *may* attach to the property, and sells . . . the property *before* the expiration of the time provided for the filing and recording of a . . . materialman's lien, he shall, on receiving the consideration for the sale . . ., pay in full any sum owing for . . . materials, unless released in writing by the person furnishing the . . . materials. . . . (Emphasis added.)

The above statute entitles the subcontractor to a personal judgment for those amounts not covered by an enforceable lien. It provides for the personal judgment since all the houses sold were sold (1) at a time when a lien might attach, (2) before the expiration of the time for filing the lien, and (3) when the lien could not attach because of the provisions of KRS 376.010(2). This is true by virtue of the fact that we proceeded under one non-severable contract whereby the time limits of KRS 376.010(2) and KRS 376.010(3), needed to perfect the lien, did not begin running until the completion of the last house. Will B. Miller Co. v. Laval, 283 Ky. 55, 140 S.W.2d 376 (1940); Paterson v. Miller, 283 Ky. 60, 140 S.W.2d 379 (1940).

[1] 54 Stat. 847 (1940), as amended, 15 U.S.C. § 80b-1 (1960).
[2] 191 F. Supp. 897 (1961).
[3] 300 F.2d 745 (1961), *aff'd on rehearing* 306 F.2d 606 (1962).

a practice known in the securities industry as "scalping."[4] This practice "operates as a fraud or deceit upon any client or prospective client" within the meaning of the Investment Advisers Act of 1940.[5] Mr. Justice Harlan dissented. *Securities & Exch. Comm'n v. Capital Gains Research Bur.*, 375 U.S. 180 (1963).

The Supreme Court in this decision has expanded the traditional common law concept of fraud. It held that Congress did not intend the fraud provisions of the Investment Advisors Act of 1940 to be confined by common law fraud concepts. In its broad construction of this act the Supreme Court did not require the Commission to prove that defendant intended to injure its clients; nor was the Commission required to show that the clients received an actual injury. Both these elements are necessary to establish fraud in its technical sense as required at common law.[6] The lower federal courts construed the act technically, requiring that at least some evidence be shown that the adviser's recommendations are not disinterested.[7] The Supreme Court, however, held that nondisclosure of the practice of scalping is sufficient in itself to establish fraud.

Because Congress did not expressly provide in this act that failure to disclose material facts is unlawful, as it did in the Securities Act of 1933,[8] courts have been reluctant to treat nondisclosure as fraud under the Investment Advisers Act. Most injunctive actions brought against investment advisers by the Commission have been dismissed for lack of proof. Many courts in the past, both state and federal, have refused to drop the rigid requirements necessary to establish fraud at common law. Failure to prove that an adviser had a dishonest intent to injure his clients (financially) has often been accepted as grounds for dismissal.

In the principal case, the Supreme Court was faced with a problem of construction. Assuming Congress adopted the concept of common law fraud in the Investment Advisers Act, did Congress intend that the courts construe the act technically or did it intend a broad remedial construction? The Court properly concluded that the act must be construed broadly to carry out its purpose which is similar to

[4] The term "scalping" refers to the practice of investment advisers trading for their own account in securities which they recommended to their clients.

[5] 54 Stat. 852, as amended, 15 U.S.C. § 80b-6, in relevant part prohibits any investment advisor: (1) to employ any device, scheme, or artifice to defraud any client or prospective client; and (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] 3 Loss, Securities Regulations 1431 (2d ed. 1961).

[7] 306 F.2d at 608-609; 191 F. Supp. 897 (1961); *contra,* Prosser, Law of Torts 538 (1955).

[8] 48 Stat. 74 (1940), as amended, 15 U.S.C. § 77 1960).

the purposes of other acts designed to eliminate fraud in the securities industry.

A first ground of support in favor of this expansive construction is found in a brief analysis of the development of fraud in courts of common law and equity. From the beginning, common law courts refused to define fraud in precise language.[9] Certain elements, difficult to prove, were held essential to establish fraud "in a damage suit between parties to an arms-length transaction."[10] These courts "regarded fraud as primarily a tort,"[11] whereas courts of equity gave fraud a broader meaning. "Equity" did not regard an intention to misrepresent as an essential element of fraud.[12] These equity courts later regarded fraud as including all concealments involving a breach of a legal or equitable relationship and "by which an undue unconscientious advantage is taken of another."[13] A duty of full disclosure of all material facts was imposed on those occupying fiduciary positions. To obtain equitable relief against one in a fiduciary position,[14] a party no longer had to establish the elements essential in an action against "a party to an arms-length transaction."

As early as 1909, in *Ridgeley v. Keene*,[15] a New York court recognized that an investment adviser, who failed to disclose to his clients an agreement that he had been paid to recommend a certain stock, had committed a fraudulent act. The adviser's plea, that the recommendation was made with the honest intention that his clients would profit, failed to excuse his nondisclosure.

A second ground of support is found in the legislative history behind the Investment Advisers Act of 1940. The Securities and Exchange Commission was authorized to make a study of investment advisory services. The report made by the Commission, with certain modifications, served as a basis for the above act.[16] The final report reflected the attitude that investment advisers occupy a fiduciary relationship with clients and should maintain an impartial and disinterested position; advisers should not engage in any transactions that might adversely affect the interests of their clients. A purpose funda-

[9] State v. Whiteaker, 118 Ore. 656, 661 (1920); 247 Pac. 1077, 1079 (1920).
[10] See cases cited in 37 C.J.S. *Fraud* § 2 (1943).
[11] Hanbury, Modern Equity 643 (8th ed. 1962).
[12] Defuniak, Handbook of Modern Equity 235 (2d ed. 1956).
[13] Moore v. Crawford, 130 U.S. 122, 128 (1889).
[14] See generally, Deeton, Fraud-Concealment and Nondisclosure, 15 Texas L. Rev. 1.
[15] 134 App. Div. 647 (1909), 119 N.Y.S. 451 (1909).
[16] See generally, *Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utilities Company Act of 1935, on Investment Trust and Investment Companies*, H. R. Doc. No. 447, 76th. Cong., 2d Sess. 1 (1939).

mental to this study, and to the securities acts coming before it, "was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*."[17] This was done in an attempt to protect the increasing number of people investing in securities.

The decision in the principal case marks a significant advance in the gradual expansion of the concept of fraud. Although "fraud" shall remain one of the most ambiguous legal concepts, this decision has cleared the way for courts to go beyond a technical construction of the fraud provisions in the Investment Advisers Act of 1940. Courts must carefully consider the balance of interests involved in construing fraud provisions under securities acts. Security dealers in fiduciary positions maintain an advantage over their clients. To insure a high standard of ethics in the securities industry, courts must guard against potential fraud by requiring disclosure of such practices as "scalping."

Leon L. Hollon

CRIMINAL LAW—HOMICIDE—INSTRUCTIONS.—Defendant was convicted of voluntary manslaughter and sentenced to twenty-one years in prison. When the offense occurred, defendant was intoxicated and bleeding from a knife wound in the throat inflicted by the deceased. Death resulted from the kicking and stomping of the deceased by the defendant. None of these facts are in dispute. *Held:* Reversed. The court ruled that the defendant was entitled to an instruction on involuntary manslaughter since he was intoxicated and there was extreme provocation. The court further said that even before the enactment of the new statute[1] dividing involuntary manslaughter into two degrees, an instruction on involuntary manslaughter would have been necessary. *Lambert v. Commonwealth*, 377 S.W.2d 76 (Ky. 1964).

There are several aspects of this case which are worthy of some comment. First is the statement by the court that the instruction on involuntary manslaughter should have been given under the law as it stood before the new statute.

The leading case on this subject is *Maulding v. Commonwealth*.[2] In that case the defendant was convicted of willful murder when he kicked and stomped his victim to death. The court said that due to the excessive brutality of the acts it could not be doubted that the

[17] See H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1932).

[1] Ky. Rev. Stat. § 435.022 (1962) [Hereinafter referred to as KRS].
[2] 172 Ky. 370, 189 S.W. 251 (1916).