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LOS ANGELES
SUPERIOR COURT

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SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF LOS ANGELES

THE PEOPLE OF THE STATE OF CALIFORNIA, BY AND THROUGH THE CALIFORNIA CORPORATIONS COMMISSIONER, Plaintiff, vs. LEEDHA, INC., D.B.A. FLINTRIDGE ASSET MANAGEMENT COMPANY, A CALIFORNIA CORPORATION; EARL D. ANSCHULTZ, AN INDIVIDUAL; AND DOES 1 THROUGH 10, INCLUSIVE, Defendants.	Case No.: BC343931 MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF PLAINTIFF'S EX PARTE APPLICATION FOR TEMPORARY RESTRAINING ORDER, ORDER TO SHOW CAUSE RE PRELIMINARY INJUNCTION DATE: 12/9/05 TIME: 8:30 a.m. DEPT.: 85 JUDGE: Honorable Dzintra Janavs ACTION FILED: 12/5/05

State of California – Department of Corporations

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I. INTRODUCTION

This case involves intentional and consistent violations of the California Corporate Securities Law ("CSL") and Orders issued by the California Corporations Commissioner ("Commissioner") by Earl D. Anschultz ("Anschultz"), underscoring the urgency for immediate injunctive relief to prevent harm to innocent members of the public. Acting Commissioner Wayne Strumpfer requests that this court issue a Temporary Restraining Order against defendant Anschultz, enjoining him from: 1) conducting business as an investment adviser without a license in violation of Corporations Code section 25230; 2) engaging in transactions, practices or a course of business to defraud or deceive any client or prospective client by an investment adviser in violation of Corporations Code section 25235(b); 3) violating the Desist and Refrain Order issued by the Commissioner on April 26, 2001; and 4) violating the Bar Order issued by the Commissioner on October 1, 2005.

Anschultz has been given numerous chances to comply with the law by the Commissioner, and each time, Anschultz blatantly ignores the Orders of the Commissioner and continues to violate the CSL. Anschultz through Leedha, Inc., d.b.a. Flintridge Asset Management Company ("Leedha"), first applied for an investment adviser certificate with the Commissioner in July of 1990. Anschultz was the President and owner of Leedha. Leedha was first suspended in 1996 for a failure to maintain books and records and tangible net capital. Leedha was given a chance to rectify the books and records and tangible net capital violations, yet failed to do so, and therefore Leedha's investment adviser license was revoked in December 1996.

On April 26, 2001, the Commissioner issued a Desist and Refrain Order against Leedha and Anschultz for engaging in unlicensed investment adviser activity. Leedha and Anschultz were given another chance to be licensed as an investment adviser after signing an "Undertaking" with the Commissioner in October 2001. Leedha and Anschultz did not abide by the requirements of the Undertaking and the Commissioner was forced to bring yet another enforcement action against Leedha and Anschultz.

In August 2004, the Commissioner filed administrative pleadings against Leedha and Anschultz seeking the revocation of Leedha's investment adviser certificate and the bar of Anschultz from the investment adviser industry. On June 29, 2005, the Commissioner and Anschultz executed

a Stipulation agreeing that Anschultz would be permanently barred from the investment adviser industry, which became effective on October 1, 2005. Leedha's investment adviser certificate was revoked on October 3, 2005, after Anschultz failed to surrender Leedha's license pursuant to the Stipulation. Anschultz, however, continues to solicit clients to give investment advice for a fee without a license by lying to investors about not having to be licensed with the Department to act as a financial consultant on their behalf. Anschultz has continued to fraudulently act as an investment adviser in violation of the law, the Desist and Refrain Order, the Stipulation and Bar Order. Members of the public who use Anschultz as an investment adviser will be in danger unless Anschultz is immediately prevented from conducting business as an investment adviser and from otherwise violating the CSL.

II. STATEMENT OF FACTS

On July 3, 1990, the Commissioner issued Leedha an investment adviser certificate. (Declaration of Rebecca E. Gutierrez, "Gutierrez," par.2, Ex.1.) Anschultz at all relevant times was the president and owner of Leedha (Gutierrez declaration, par.4, Ex.11-12.) However, on July 3, 2000, Leedha's domestic corporation certificate was suspended by the Franchise Tax Board and never reinstated. (Gutierrez declaration, par.4, Ex.10.)

On October 28, 1996, the Commissioner issued an Order summarily suspending Leedha's investment adviser certificate for its failure to maintain books and records and tangible net capital in accordance with Corporations Code section 25241 and California Code of Regulations, title 10, sections 260.241.1, 260.241.2, and 260.241.3. In this Order, Leedha was given 30 days to come into compliance. If Leedha failed to comply within 30 days, a revocation Order would be issued. Leedha failed to comply within 30 days as demanded. Therefore, on December 26, 1996, the Commissioner set aside the Order of Suspension and issued a Summary Revocation Order for Leedha's books and records violations. (Gutierrez declaration, par.2, Ex. 2.)

On March 20, 2001 the Commissioner received a customer complaint showing that Anschultz through Leedha was acting as an investment adviser. During this time period, Leedha and Anschultz did not have an investment adviser certificate. On April 26, 2001, the Commissioner

issued a Desist and Refrain Order to Leedha and Anschultz for engaging in unlicensed investment adviser activity. (Gutierrez declaration, par.2, Ex. 3.)

In October 2001, the Commissioner and Anschultz entered into an agreement signed by both parties entitled "Undertaking". (Gutierrez declaration, par.2, Ex. 4.)

Pursuant to the Undertaking, the Commissioner once again issued an investment adviser certificate to Leedha on October 30, 2001. (Gutierrez declaration, par.2, Exs. 4-5.) In the Undertaking, however, the Commissioner imposed conditions on Leedha's new investment adviser certificate, requiring Leedha to file the following: 1) monthly reports with the Commissioner stating that Leedha was in compliance with the capital requirements of California Code of Regulations, title 10, section 260.237.1, except that if during the first 12 months of the reporting period there were no violations of section 260.237.1, the reports were due quarterly; and 2) quarterly reports stating that Leedha was in compliance with the books and records requirements of California Code of Regulations, title 10, sections 260.241.1, 260.241.2, and 260.241.3, except that if during the first 12 months there were no violations, then the reports were due biannually. Both reports were due within fifteen days of the period covered and were to continue for a two year period until October 31, 2003. (Gutierrez declaration, par.2, Ex. 4.)

On May 1, 2003, the Department commenced a field examination of Leedha. As a result of this examination, it was determined that Leedha had violated the terms of the October 2001 Undertaking, which entitled the Department to summarily revoke Leedha's investment adviser certificate. (Declaration of Cheryl Bryan, "Bryan," par.4.) Leedha was initially required to submit twelve monthly reports regarding its compliance with the capital requirements under California Code of Regulations, title 10, section 260.237.1. (Bryan declaration, par.4; Gutierrez declaration, par.2, Ex. 4.) Leedha's first monthly report due for November 2001 was delayed and received late by the Department. (Bryan declaration, par.4, Ex. A.) Leedha failed to submit its monthly reports for January through July 2002. (Bryan declaration, par.4, Ex. A.) In September 2002, the Department received a letter from Leedha's consultant Mary Cobb requesting that the Department take the current report as bringing Leedha current through August 2002. (Bryan declaration, par.4.) The Department agreed to this request. Leedha did submit its monthly reports for September through

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November 2002. (Bryan declaration, par.4, Ex. A.) However, once these reports became due quarterly, Leedha never submitted any further reports. (Bryan declaration, par.4, Ex. A.)

Furthermore, Leedha was required, pursuant to the Undertaking, to submit quarterly reports showing compliance with California Code of Regulations, title 10, sections 260.241.1, 260.241.2 and 260.241.3. (Bryan declaration, par.5.) Leedha failed to provide the quarterly reports due for the periods November 2001 through January 2002 and February through April 2002. (Bryan declaration, par.5, Ex. B.) In a letter from Mary Cobb, a request was made to take the current report submitted for the quarter May through July 2002 as bringing Leedha current through August 2002. (Bryan declaration, par.5.) The Department agreed to this request. Leedha, however, failed to produce the quarterly report due for August through October 2002 and never produced any biannual reports subsequently due as provided in the Undertaking regarding compliance with the books and records requirements under California Code of Regulations, title 10, sections 260.241.1, 260.241.2 and 260.241.3. (Bryan declaration, par.5, Ex. B.)

During its May 2003 examination, the Commissioner not only determined that Leedha failed to comply with the terms of the Undertaking, but also discovered that Leedha continued to violate the same books and records requirements by failing to comply with California Code of Regulations, title 10, sections 260.241.2 and 260.241.3, by not filing an annual financial report, and by failing to maintain specific books and records, respectively. (Bryan declaration, par.6.) Furthermore, Leedha misrepresented to its clients the nature of the investment advisory fees charged, by not fully and clearly disclosing that clients would also be charged a fee based on assets that included securities purchased on margin. (Bryan declaration, par.6.) Leedha also overcharged some clients by double billing, calculating fees based on overvalued assets, charging clients fees while unlicensed and for charging on margin balances. (Bryan declaration, par.6.)

On August 17, 2004, the Commissioner served Leedha and Anschultz by certified mail with the following administrative pleadings: 1) a Notice of Intention to Issue an Order Revoking Leedha's Certificate as an Investment Adviser Pursuant to Corporations Code Section 25232 and Barring Anschultz from any Position of Employment, Management or Control of any Investment Adviser, Broker-Dealer or Commodity Adviser Pursuant to Corporations Code Section 25232.1, with Claim

for Ancillary Relief in the Form of Disgorgement and Costs, and Order Levying Administrative Penalties Pursuant to Corporations Code Section 25252; 2) Statement to Respondent; 3) Accusation to Revoke Investment Adviser Certificate of Leedha, Inc.; and Bar Earl D. Anschultz; with Claim for Ancillary Relief in The Form of Disgorgement and Attorney Fees; 4) Statement in Support of Order to Levy Administrative Penalties; 5) Notices of Defense; and 6) Government Code Sections 11507.5, 11507.6, 11507.7. (Gutierrez declaration, par.2, Ex.6.) On or about August 23, 2004, Defendants Leedha and Anschultz received the administrative pleadings. On or about August 26, 2004, Defendants filed Notices of Defense with the Commissioner, requesting a hearing. (Gutierrez declaration, par.2, Ex.6.)

On June 29, 2005, in lieu of a hearing on the administrative pleadings, the Commissioner and Defendants Leedha and Anschultz executed a Stipulation ("Stipulation") agreeing to the following: 1) an Order permanently barring Anschultz from any position of employment, management and control of any investment adviser, issued on October 1, 2005; 2) Leedha's surrender of its investment adviser license, by no later than October 1, 2005, with the provision that if Leedha did not surrender its investment adviser license by October 1, 2005, then the Commissioner could immediately revoke Leedha's investment adviser license and Leedha and Anschultz waived their rights to a hearing or appeal pursuant to the CSL or any other relevant provision of law; 3) that Leedha and Anschultz may not take on any new clients and may not overcharge any existing clients, with the provision that if the Department determined that Leedha charged fees in excess of the fees stated in the clients' current investment advisory agreement from the date the Stipulation was entered until October 1, 2005, then Leedha agreed to pay a fine in the amount of $5,000 for each client overcharged; 4) Leedha will disgorge any overcharged investment advisory fees, which are estimated to be approximately $55,056.25, to its investment adviser clients and must provide proof that the clients have been reimbursed by no later than December 31, 2005; 5) that Leedha would contact its clients in writing within ten (10) days from the date of the execution of the Stipulation, disclose the Stipulation, including the stipulated Order permanently barring Anschultz, and to provide proof to the Department that it has done so; and 6) that Leedha will cooperate with two field examinations to occur sometime within one year from the date the Stipulation is executed and that

Leedha must either provide adequate space for the examination where the books and records are maintained or bring all books and records to the Department for the exam. (Gutierrez declaration, par.2, Ex.7.)

On October 1, 2005, the Commissioner issued the stipulated order permanently barring Anschultz from any position of employment, management and control of any investment adviser. (Gutierrez declaration, par.2, Ex.8.) On October 3, 2005, after Leedha failed to surrender its investment adviser license by October 1, 2005, as agreed to in the Stipulation, the Commissioner issued an Order Revoking Certificate to Leedha. (Gutierrez declaration, par.2, Ex.9.)

In or around September 2005 and continuing thereafter through October 2005, Anschultz solicited clients to act as their financial consultant. (Declaration of Robert DeBlasis, "DeBlasis", pars.7-8 and Declaration of Stephen Russell, "Russell", par.6.) Orally, and in a written proposal to some clients, Anschultz offered to act as a financial consultant in an individual capacity for a fee, as of October 1, 2005, and after. (DeBlasis, pars.2 and 7, Ex. B. and Russell, par.6.) The written proposal states that Anschultz as an individual will advise on client investment portfolios, execute trades with brokers with the client's limited power of attorney, and work for a fixed monthly fee. (DeBlasis, par.7, Ex. B.) Anschultz either told clients that he did not need to be licensed or failed to disclose that he did in fact need a license to act as their financial consultant. (DeBlasis, par. 9 and Russell, par.6.) Furthermore, Anschultz in the past has represented to his clients while preparing tax returns for them that he was an attorney. (DeBlasis, par.10, Ex. C.) Anschultz, however, has not been entitled to practice law since he resigned from the California State Bar in 1985 with charges pending. (Gutierrez declaration, par.5, Ex.13.)

III. ARGUMENT

A. THE COMMISSIONER HAS THE AUTHORITY TO BRING THIS ACTION AND TO SEEK A TEMPORARY RESTRAINING ORDER

Corporations Code section 25530 provides, in pertinent part, as follows:

(a) Whenever it appears to the commissioner that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this division or any rule or order hereunder, the commissioner may in the commissioner's discretion

bring an action in the name of the people of the State of California in the superior court to enjoin the acts or practices or to enforce compliance with this law or any rule or order hereunder...

A government entity seeking to enjoin the alleged violations of a statute, which expressly authorizes injunctive relief to protect the public interest, need not allege or prove equitable considerations, such as inadequacy of a legal remedy, or grave or irreparable harm as a prerequisite to obtaining injunctive relief. (*IT Corp. v. County of Imperial* (1983) 35 Cal.3d 63; *Porter v. Fisk* (1946) 74 Cal.App.2d 332, 338.) According to the California Supreme Court, once a governmental entity establishes a reasonable probability that it will prevail on the merits, a rebuttable presumption arises that the potential harm to the public outweighs the potential harm to the defendant. (*IT Corp. v. County of Imperial*, supra, 35 Cal.3d at 72.)

Anschultz violated the CSL by providing investment advice for a fee without a license and by engaging in transactions, practices or a course of business to defraud or deceive clients and also violated various Orders issued by the Commissioner, all of which permit injunctive relief under the CSL. Anschultz continues to act in violation of the law by offering investment advice for a fee without a license and by lying to investors to continue to lure them in to his scheme.

Defendant Anschultz has repeatedly violated California Corporations Code section 25230 by engaging in unlicensed investment adviser activity, has violated Corporations Code section 25235(b) by engaging in transactions, practices or a course of business to defraud, and has also violated various Orders issued by the Commissioner and continues to do so. Therefore, the Commissioner on behalf of the People of the State of California has satisfied the requirements for bringing this action and is entitled to a temporary restraining order and the issuance of an order to show cause for a preliminary injunction that would enjoin Defendant Anschultz from: 1) continuing to operate and represent himself as a financial consultant or in any other capacity where he gives recommendations and advice as to the advisability of securities investments for a fee without a license in violation of Corporations Code section 25230; 2) engaging in transactions, practices or a course of business to defraud or deceive any client or prospective client by an investment adviser in violation of Corporations Code section 25235(b); and 3) violating any of the Commissioner's Orders.

B. DEFENDANT ANSCHULTZ HAS ACTED AS AN UNLICENSED INVESTMENT ADVISER IN VIOLATION OF CALIFORNIA CORPORATIONS CODE SECTION 25230 AND SHOULD BE ENJOINED FROM DOING SO UNDER CALIFORNIA CORPORATIONS CODE SECTION 25530.

California Corporations Code Section 25230, in relevant part, provides:

(a) It is unlawful for any investment adviser to conduct business as an investment adviser in this state unless the investment adviser has first applied for and secured from the commissioner a certificate, then in effect, authorizing the investment adviser to do so or unless the investment adviser is exempted by the provisions of Chapter 1 (commencing with Section 25200) of this part or unless the investment adviser is subject to Section 25230.1.

California Corporations Code Section 25009, in relevant part, provides that:

(a) "Investment adviser" means 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 the compensation and as part of a regular business, publishes analyses or reports concerning securities....

California Corporations Code Section 25013 defines a person, in relevant part as:

... an individual, a corporation, a partnership, a limited liability company, a joint venture, an association, a joint stock company, a trust, an unincorporated organization, a government, or a political subdivision of a government.

On June 29, 2005, Anschultz executed a Stipulation, which included an Order permanently barring Anschultz from the employment, management and control of any investment adviser, which became effective October 1, 2005. (Gutierrez declaration, par.2, Ex.8.) On October 3, 2005, the Commissioner issued a revocation order taking away Leedha's investment adviser certificate. (Gutierrez declaration, par.2, Ex.9.)

In or about September and continuing through October 2005, Anschultz held himself out to clients as a financial consultant. (DeBlasis, pars.2, 7 and 8, Ex. B. and Russell, par.6.) Orally, and in a written proposal to some clients, Defendant Anschultz as an individual offered to advise on client's investment portfolios for a fixed monthly fee as of October 1, 2005, and after. (DeBlasis, pars.2 and 7, Ex. B. and Russell, par.6.) Defendant Anschultz continues to engage in the business of advising clients as to the value of securities and as to the advisability of purchasing and selling securities for compensation, even after his bar from the investment adviser industry and the revocation of Leedha's investment adviser certificate, and as such is acting as an investment adviser within the meaning of California Corporations Code Section 25009. Anschultz, by acting as an investment adviser within the meaning of California Corporations Code Section 25009 without a certificate from the Commissioner, is acting as an unlicensed investment adviser in violation of California Corporations Code Section 25230. Defendant Anschultz is conducting investment adviser business that is not exempt from the licensing requirements mandated by California Corporations Code Section 25230. Unless enjoined by this Court, Defendant Anschultz will continue to violate California Corporations Code Section 25230.

C. DEFENDANT ANSCHULTZ ENGAGED IN TRANSACTIONS, PRACTICES, OR A COURSE OF BUSINESS TO DEFRAUD CLIENTS IN VIOLATION OF CALIFORNIA CORPORATIONS CODE SECTION 25235(b) AND SHOULD BE ENJOINED UNDER CALIFORNIA CORPORATIONS CODE SECTION 25530

Corporations Code section 25235(b) provides in part, that it is unlawful for any investment adviser, directly or indirectly, in this state "To engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon any client or prospective client."

Federal cases interpreting the federal Investment Advisers Act of 1940, ("IA Act") may be followed in applying investment adviser provisions of the CSL. (*Los Angeles Metro. Transit Authority v. Bhd. Of R.R. Trainman* (1960) 54 Cal.2d 684, 688-689.) In a civil action to enjoin the anti-fraud provisions of the IA Act, the Supreme Court recognized the "delicate fiduciary

relationship of the investment advisory relationship" and held that the SEC was not required to prove the defendant's intent to injure, or to prove actual injury. (*Securities and Exchange Commission v. Capital Gains Research Bureau* (1963) 375 U.S. 180, 191.) The court also held that failure to disclose a material fact to the investment adviser client, in addition to the more obvious fraudulent statement, constitutes a "fraud or deceit" for purposes of the IA Act. (*Id.* at 200.) Defendant Anschultz made material misrepresentations by either fraudulently telling clients that he does not need to be licensed as an investment adviser to act as a financial consultant while managing their investment portfolios for a fixed monthly fee or by omitting to tell other clients that he needs a license to do so. (DeBlasis, par.9 and Russell, par.6.) As such, Anchultz is conducting a business that operates as a fraud or deceit upon any client or prospective client in violation of Corporations Code section 25235(b). Therefore Anschultz should be enjoined from engaging in any transaction, practice, or course of business that operates or would operate as a fraud or deceit upon any client or prospective client.

D. DEFENDANT ANSCHULTZ HAS VIOLATED THE DESIST AND REFRAIN ORDER AND SHOULD BE ENJOINED UNDER CALIFORNIA CORPORATIONS CODE SECTION 25530.

On or about April 26, 2005, the Commissioner issued an administrative order against Defendants Anschultz and Leedha, ordering them to immediately desist and refrain from engaging in unlicensed investment adviser business in the state of California, unless and until it applied for and secured from the Commissioner a certificate authorizing Anschultz and Leedha to conduct business as an investment adviser or unless Anschultz and Leedha are exempt from the provisions of Corporations Code section 25230. (Gutierrez declaration, par.2, Ex. 3.)

On October 1, 2005, the Commissioner issued an Order permanently barring Anschultz from any position of employment, management and control of any investment adviser. (Gutierrez declaration, par.2, Ex.8.) On October 3, 2005, the Commissioner revoked Leedha's investment adviser certificate. (Gutierrez declaration, par.2, Ex.9.)

Notwithstanding the receipt and knowledge of the Desist and Refrain Order, Defendant Anschultz continues to engage in the business of advising clients as to the value of securities and as to the advisability of purchasing and selling securities for compensation, and as such is acting as an

investment adviser in the state of California without a license in violation of the Commissioner's Order, and therefore should be enjoined from doing so.

E. DEFENDANT ANSCHULTZ HAS VIOLATED THE BAR ORDER AND SHOULD BE ENJOINED UNDER CALIFORNIA CORPORATIONS CODE SECTION 25530.

On or about June 29, 2005, Anschultz entered into a Stipulation, which included an order permanently barring Anschultz from any position of employment, management and control of any investment adviser, which became effective October 1, 2005. (Gutierrez declaration, par.2, Ex.8.)

Starting in September 2005 and continuing through October 2005, orally, and in a written proposal to some clients, Defendant Anschultz as an individual offered clients to act as their financial consultant to advise them on investment portfolios for a fixed fee as of October 1, 2005, and after. (DeBlasis, pars.2, 7 and 8, Ex. B. and Russell, par.6.) Defendant Anschultz is therefore continuing to work in a position of employment, management and control of an investment adviser in violation of the Bar Order. Notwithstanding the stipulated bar order, Defendant Anschultz continues to act as an investment adviser in violation of this Order, and therefore should be enjoined from doing so.

IV. THE POTENTIAL DANGER TO THE PUBLIC JUSTIFIES THE EX PARTE ISSUANCE OF A TEMPORARY RESTRAINING ORDER

One of the Legislature's main purposes in enacting the CSL was to "protect the public against the imposition of insubstantial, unlawful and fraudulent stock and investment schemes...and to promote full disclosure..." *People v. Park* (1978) 87 Cal.App.3d 550, 565.

If Anschultz is allowed to continue to operate as an investment adviser without a license and engage in transactions, practices or a course of business to defraud, the public is placed at an unreasonable risk. Anschultz managing client's investment portfolios for a fee without any license and by misrepresenting and/or omitting material facts is exactly the risk of harm that the CSL was put in place to guard against. The court's order of immediate, *ex parte* relief is proper, necessary and should be granted.

V. CONCLUSION

Defendant Anschultz has: 1) violated California Corporations Code section 25230 by acting

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as an investment adviser without a license; (2) violated California Corporations Code section 25235(b) by engaging in transactions, practices or a course of business to defraud or deceive any client or prospective client; (3) violated the Desist and Refrain Order issued on April 26, 2001; and (4) violated the Bar order issued on October 1, 2005. The public has been exposed to a real and continuing danger through the deception of an individual, who has been given numerous opportunities to correct his mistakes. Anschultz has displayed a history of acting as a licensed investment adviser despite not possessing the necessary license to do so. Anschultz shows no respect for the laws and regulations put in place to protect consumers. For all of these reasons, the Commissioner respectfully requests this Court issue a temporary restraining order that immediately enjoins Anschultz from: 1) conducting business as an investment adviser without a license in violation of Corporations Code section 25230; 2) engaging in transactions, practices or a course of business to defraud or deceive any client or prospective client in violation of Corporations Code section 25235(b); 3) violating the Desist and Refrain Order issued by the Commissioner on April 26, 2001; and 4) violating the Bar Order issued by the Commissioner on October 1, 2005.

Dated: December 7, 2005

WAYNE STRUMPFER
Acting California Corporations Commissioner

By _____
MICHELLE LIPTON
Senior Corporations Counsel
Attorneys for Plaintiff

State of California – Department of Corporations

APPENDIX 1

LEXSEE 375 U.S. 180

SECURITIES AND EXCHANGE COMMISSION v. CAPITAL GAINS RESEARCH BUREAU, INC., ET AL.

No. 42

SUPREME COURT OF THE UNITED STATES

375 U.S. 180; 84 S. Ct. 275; 11 L. Ed. 2d 237; 1963 U.S. LEXIS 2446

October 21, 1963, Argued
December 9, 1963, Decided

PRIOR HISTORY:

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

DISPOSITION:

306 F.2d 606, reversed and remanded.

LexisNexis(R) Headnotes

SYLLABUS:

Under the Investment Advisers Act of 1940, the Securities and Exchange Commission may obtain an injunction compelling a registered investment adviser to disclose to his clients a practice of purchasing shares of a security for his own account shortly before recommending that security for long-term investment and then immediately selling his own shares at a profit upon the rise in the market price following the recommendation, since such a practice "operates as a fraud or deceit upon any client or prospective client," within the meaning of the Act. Pp. 181-201.

(a) Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit" upon a client, did not intend to require proof of intent to injure and actual injury to the client; it intended the Act to be construed like other securities legislation "enacted for the purpose of avoiding frauds," not technically and restrictively, but rather flexibly to effectuate its remedial purposes. Pp. 186-195.

(b) The Act empowers the courts, upon a showing such as that made here, to require an adviser to make full and frank disclosure of his practice of trading on the effect of his recommendations. Pp. 195-197.

(c) In the light of the evident purpose of the Act to substitute a philosophy of disclosure for the philosophy of *caveat emptor*, it cannot be assumed that the omission from the Act of a specific proscription against nondisclosure was intended to limit the application of the antifraud and antideceit provisions of the Act so as to render the Commission impotent to enjoin suppression of material facts. Pp. 197-199.

(d) The 1960 amendment to the Act does not justify a narrow interpretation of the original enactment. Pp. 199-200.

(e) Even if respondents' advice was "honest," in the sense that they believed it was sound and did not offer it for the purpose of furthering personal pecuniary objectives, the Commission was entitled to an injunction requiring disclosure. Pp. 200-201.

COUNSEL:

David Ferber argued the cause for petitioner. With him on the brief were Solicitor General Cox, Daniel M. Friedman and Philip A. Loomis, Jr.

Leo C. Fennelly argued the cause and filed a brief for respondents.

JUDGES:

Warren, Black, Clark, Harlan, Brennan, Stewart, White, Goldberg; Douglas took no part in the consideration or decision of this case.

OPINIONBY:

GOLDBERG

OPINION:

[*181] [***240] [**277] MR. JUSTICE GOLDBERG delivered the opinion of the Court.

[***HR1A]

We are called upon in this case to decide whether under the Investment Advisers Act of 1940 n1 the Securities and Exchange Commission may obtain an injunction compelling a registered investment adviser to disclose to his clients a practice of purchasing shares of a security for his own account shortly before recommending that security for long-term investment and then immediately selling the shares at a profit upon the rise in the market price following the recommendation. The answer to this question turns on whether the practice -- known in the trade as "scalping" -- "operates as a fraud or deceit upon any client or prospective client" within the meaning of the Act. n2 We hold that [***241] it does [**278] and that the Commission may "enforce compliance" with the Act by obtaining an [*182] injunction requiring the adviser to make full disclosure of the practice to his clients. n3

n1 54 Stat. 847, as amended, *15 U. S. C. § 80b-1 et seq.*

n2 54 Stat. 852, as amended, *15 U. S. C. (Supp. IV) § 80b-6,* provides in relevant part that:

"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. . . ."

n3 54 Stat. 853, as amended, *15 U. S. C. (Supp. IV) § 80b-9,* provides in relevant part that:

"(e) Whenever it shall appear to the Commission that any person has engaged, is engaged, or is about to engage in any act or practice constituting a violation of any provision of this subchapter, or of any rule, regulation, or order hereunder, or that any person has aided, abetted, counseled, commanded, induced, or procured, is aiding, abetting, counseling, commanding, inducing, or procuring, or is about to aid, abet, counsel, command, induce, or procure such a violation, it may in its discretion bring an action in the proper district court of the United States, or the proper United States court of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices and to enforce compliance with this subchapter of any rule, regulation, or order hereunder. Upon a showing that such person has engaged, is engaged, or is about to engage in any such act or practice, or in aiding, abetting, counseling, commanding, inducing, or procuring any such act or practice, a permanent or temporary injunction or decree or restraining order shall be granted without bond."

The Commission brought this action against respondents in the United States District Court for the Southern District of New York. At the hearing on the application for a preliminary injunction, the following facts were established. Respondents publish two investment advisory services, one of which -- "A Capital Gains Report" -- is [*183] the subject of this proceeding. The Report is mailed monthly to approximately 5,000 subscribers who each pay an annual subscription price of $ 18. It carries the following description:

"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."

Between March 15, 1960, and November 7, 1960, respondents, on six different occasions, purchased shares of a particular security shortly before recommending it in the Report for long-term investment. On each occasion, there was an increase in the market price and the volume of trading of the recommended security within a few days after the distribution of the Report. Immediately thereafter, respondents sold their shares of these securi-

ties at a profit. n4 They did not disclose any aspect of these transactions to their clients or prospective clients.

n4 See Appendix, *infra*, p. 202.

On the basis of the above facts, the Commission requested a preliminary **[***242]** injunction as necessary to effectuate the purposes of the Investment Advisers Act of 1940. The injunction would have required respondents, in any future Report, to disclose the material facts concerning, *inter alia*, 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 . . . ." n5

n5 The requested injunction reads in full as follows:

"WHEREFORE the plaintiff demands a temporary restraining order, preliminary injunction and final injunction:

"1. Enjoining the defendants Capital Gains Research Bureau, Inc. and Harry P. Schwarzmann, their agents, servants, employees, attorneys and assigns, and each of them, while the said Capital Gains Research Bureau, Inc. is an investment adviser, directly and indirectly, by the use of the mails or any means or instrumentalities of interstate commerce from:

"(a) Employing any device, scheme or artifice to defraud any client or prospective client by failing to disclose the material facts concerning

"(1) The purchase by defendant, Capital Gains Research Bureau, Inc., of securities within a very short period prior to the distribution of a recommendation by said defendant to its clients and prospective clients for purchase of said securities;

"(2) The intent to sell and the sale of said securities by said defendant so recommended to be purchased within a very short period after distribution of said recommendation to its clients and prospective clients;

"(3) Effecting of short sales by said defendant within a very short period prior to the distribution of a recommendation by said defendant to its clients and prospective clients to dispose of said securities;

"(4) The intent of said defendant to purchase and the purchase of said securities to cover its short sales;

"(5) The purchase by said defendant for its own account of puts and calls for securities within a very short period prior to the distribution of a recommendation to its clients and prospective clients for purchase or disposition of said securities.

"(b) Engaging in any transaction, practice and course of business which operates as a fraud or deceit upon any client or prospective client by failing to disclose the material facts concerning the matters set forth in demand 1 (a) hereof."

[*184] The District Court denied the request for a preliminary injunction, holding that the words "fraud" and "deceit" **[**279]** are used in the Investment Advisers Act of 1940 "in their technical sense" and that the Commission had failed to show an intent to injure clients or an actual loss of money to clients. *191 F.Supp. 897.* The Court of Appeals for the Second Circuit, sitting *en banc*, by a 5-to-4 vote accepted the District Court's limited construction of "fraud" and "deceit" and affirmed the denial **[*185]** of injunctive relief. n6 *306 F.2d 606.* The majority concluded that no violation of the Act could be found absent proof that "any misstatements or false figures were contained in any of the bulletins"; or that "the investment advice was unsound"; or that "defendants were being bribed or paid to tout a stock contrary to their own beliefs"; or that "these bulletins were a scheme **[***243]** to get rid of worthless stock"; or that the recommendations were made "for the purpose of endeavoring artificially to raise the market so that [respondents] might unload [their] holdings at a profit." *Id., at 608-609.* The four dissenting judges pointed out that "the common-law doctrines of fraud and deceit grew up in a business climate very different from that involved in the sale of securities," and urged a broad remedial construction of the statute which would encompass respondents' conduct. *Id., at 614.* We granted certiorari to consider the question of statutory construction because of its importance to the investing public and the financial community. *371 U.S. 967.*

n6 The case was originally heard before a panel of the Court of Appeals, which, with one judge dissenting, affirmed the District Court. *300 F.2d 745.* Rehearing *en banc* was then ordered.

The Court of Appeals purported to recognize that "federal securities laws are to be construed broadly to effectuate their remedial purpose." *306*

F.2d 606, 608. But by affirming the District Court's "technical" construction of the Investment Advisers Act of 1940 and by requiring proof of "misstatements," unsound advice, bribery, or intent to unload "worthless stock," the court read the statute, in effect, as confined by traditional common-law concepts of fraud and deceit.

[*HR2]** The decision in this case turns on whether Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit upon any client or prospective client," intended to require the Commission to establish fraud and deceit "in their technical sense," including **[*186]** intent to injure and actual injury **[**280]** to clients, or whether Congress intended a broad remedial construction of the Act which would encompass nondisclosure of material facts. For resolution of this issue we consider the history and purpose of the Investment Advisers Act of 1940.

I.

[*HR3]** The Investment Advisers Act of 1940 was the last in a series of Acts designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's. n7 It was preceded by the Securities Act of 1933, n8 the Securities Exchange Act of 1934, n9 the Public Utility Holding Company Act of 1935, n10 the Trust Indenture Act of 1939, n11 and the Investment Company Act of 1940. n12 A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry. n13 As we recently said in a related context, "It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail" **[*187]** in every facet of the securities industry. *Silver v. New York Stock Exchange, 373 U.S. 341, 366.*

n7 See generally Douglas and Bates, The Federal Securities Act of 1933, *43 Yale L. J. 171 (1933);* Loomis, The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940, *28 Geo. Wash. L. Rev. 214 (1959).* Shulman, Civil Liability and the Securities Act, *43 Yale L. J. 227 (1933).* Cf. Galbraith, The Great Crash (1955).

n8 48 Stat. 74, as amended, *15 U. S. C. § 77a et seq.*

n9 48 Stat. 881, as amended, *15 U. S. C. § 78a et seq.*

n10 49 Stat. 838, as amended, *15 U. S. C. § 79 et seq.*

n11 53 Stat. 1149, as amended, *15 U. S. C. § 77aaa et seq.*

n12 54 Stat. 789, as amended, *15 U. S. C. § 80a-1 et seq.*

n13 See H. R. Rep. No. 85, 73d Cong., 1st Sess. 2, quoted in *Wilko v. Swan, 346 U.S. 427, 430.*

The Public Utility Holding Company Act of 1935 "authorized and directed" the Securities and Exchange Commission "to make a study of the functions and activities of investment trusts and investment companies . . . ." n14 Pursuant **[***244]** to this mandate, the Commission made an exhaustive study and report which included consideration of investment counsel and investment advisory services. n15 This aspect of the study and report culminated in the Investment Advisers Act of 1940.

n14 49 Stat. 837, *15 U. S. C. § 79z-4.*

n15 While the study concentrated on investment advisory services which provide personalized counseling to investors, see Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H. R. Doc. No. 477, 76th Cong., 2d Sess., 1 (hereinafter cited as SEC Report) the Senate Committee on Banking and Currency did receive communications from publishers of investment advisory services, see, *e. g.*, Hearings on S. 3580 before Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess., pt. 3 (Exhibits), 1063, and the Act specifically covers "any person who, for compensation, engages in the business of advising others, either directly or through publication or writings . . . ." 54 Stat. 847, *15 U. S. C. § 80b-2.*

The report reflects the attitude -- shared by investment advisers and the Commission -- that investment advisers could not "completely perform their basic function -- furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments -- unless all conflicts of interest between the investment counsel and the client were removed." n16 The **[**281]** report stressed that affiliations by investment **[*188]** advisers with investment bankers, or corporations might be "an impediment to a disinterested, objective, or critical attitude toward an investment by clients . . . ." n17

n16 SEC Report, at 28.

n17 *Id.*, at 29.

This concern was not limited to deliberate or conscious impediments to objectivity. Both the advisers and the Commission were well aware that whenever advice to a client might result in financial benefit to the adviser -- other than the fee for his advice -- "that advice to a client might in some way be tinged with that pecuniary interest [whether consciously or] subconsciously motivated . . . ." n18 The report quoted one leading investment adviser who said that he "would put the emphasis . . . on subconscious" motivation in such situations. n19 It quoted a member of the Commission staff who suggested that a significant part of the problem was not the existence of a "deliberate intent" to obtain a financial advantage, but rather the existence "subconsciously [of] a prejudice" in favor of one's own financial interests. n20 The report incorporated the Code of Ethics and Standards of Practice of one of the leading investment counsel associations, which contained the following canon:

"[An 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." n21 (Emphasis added.)

n18 *Id.*, at 24.

n19 *Ibid.*

n20 *Ibid.*

n21 *Id.*, at 66-67.

Other canons appended to the report announced the following guiding principles: that compensation for investment advice "should consist exclusively of direct **[*189]** charges to clients for services rendered"; n22 that the adviser should devote his time "exclusively to the performance" of his advisory function; n23 **[***245]** that he should not "share in profits" of his clients; n24 and that he should not "directly or indirectly engage in any activity which may jeopardize [his] ability to render unbiased investment advice." n25 These canons were adopted "to the end that the quality of services to be rendered by investment counselors may measure up to the high standards which the public has a right to expect and to demand." n26

n22 *Id.*, at 66.

n23 *Id.*, at 65.

n24 *Id.*, at 67.

n25 *Id.*, at 29.

n26 *Id.*, at 66.

One activity specifically mentioned and condemned by investment advisers who testified before the Commission was "*trading by investment counselors for their own account in securities in which their clients were interested* . . . ." n27

n27 *Id.*, at 29-30. (Emphasis added.)

This study and report -- authorized and directed by statute n28 -- culminated in the preparation and introduction by Senator Wagner of the bill which, with some changes, became the Investment Advisers Act of 1940. n29 In its "declaration of policy" the original bill stated that

"Upon the basis of facts disclosed by the record and report of the Securities and Exchange Commission . . . it is hereby declared that the national public interest and the interest of investors are adversely affected -- . . . (4) when the business of investment advisers is so conducted as to defraud or mislead investors, or to enable such advisers **[**282]** to relieve themselves of their fiduciary obligations to their clients. **[*190]** "It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is presently practi-

cable to eliminate the abuses enumerated in this section." S. 3580, 76th Cong., 3d Sess., § 202.

n28 See text accompanying note 14, *supra*.

n29 S. 3580, 76th Cong., 3d Sess.

Hearings were then held before Committees of both Houses of Congress. n30 In describing their profession, leading investment advisers emphasized their relationship of "trust and confidence" with their clients n31 and the importance of "strict limitation of [their right] to buy and sell securities in the normal way if there is any chance at all that to do so might seem to operate against the interests of clients and the public." n32 The president of the Investment Counsel Association of America, the leading investment counsel association, testified that the

"two fundamental principles upon which the pioneers in this new profession undertook to meet the growing need for unbiased investment information and guidance were, first, that they would limit their efforts and activities to the study of investment problems from the investor's standpoint, not engaging in any other activity, such as security selling or brokerage, which might directly or indirectly bias their investment judgment; and, second, that their remuneration for this work would consist solely of definite, professional fees fully disclosed in advance." n33

n30 Hearings on S. 3580 before Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. (hereinafter cited as Senate Hearings). Hearings on H. R. 10065 before Subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess. (hereinafter cited as House Hearings).

n31 Senate Hearings, at 719.

n32 *Id.*, at 716.

n33 *Id.*, at 724.

[*191] Although **[***246]** certain changes were made in the bill following the hearings, n34 there is nothing to indicate an intent to alter the fundamental purposes of the legislation. The broad proscription against "any . . . practice . . . which operates . . . as a fraud or deceit upon any client or prospective client" remained in the bill from beginning to end. And the Committee Reports indicate a desire to preserve "the personalized character of the services of investment advisers," n35 and to eliminate conflicts of interest between the investment adviser and the clients n36 as safeguards both to "unsophisticated investors" and to "bona fide investment counsel." n37 The Investment Advisers Act of 1940 thus reflects a congressional recognition **[**283]** "of the delicate fiduciary nature of an investment advisory relationship," n38 as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser -- consciously **[*192]** or unconsciously -- to render advice which was not disinterested. It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold, therefore, 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.

n34 The bill as enacted did not contain a section attributing specific abuses to the investment adviser profession. This section was eliminated apparently at the urging of the investment advisers who, while not denying that abuses had occurred, attributed them to certain fringe elements in the profession. They feared that a public and general indictment of all investment advisers by Congress would do irreparable harm to their fledgling profession. See, *e. g.*, Senate Hearings, at 715-716. It cannot be inferred, therefore, that the section was eliminated because Congress had concluded that the abuses had not occurred, or because Congress did not desire to prevent their repetition in the future. The more logical inference, considering the legislative background of the Act, is that the section was omitted to avoid condemning an entire profession (which depends for its success on continued public confidence) for the acts of a few.

n35 H. R. Rep. No. 2639, 76th Cong., 3d Sess. 28 (hereinafter cited as House Report). See also S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (hereinafter cited as Senate Report).

n36 See Senate Report, at 22.

n37 *Id.*, at 21.

n38 2 Loss, Securities Regulation (2d ed. 1961), 1412.

[*HR4]** This conclusion moreover, is not in derogation of the common law of fraud, as the District Court

and the majority of the Court of Appeals suggested. To the contrary, it finds support in the process by which the courts have adapted the common law of fraud to the commercial transactions of our society. It is true that at common law intent and injury have been deemed essential elements in a damage suit between parties to an arm's-length transaction. n39 But this is not such an action. n40 **[***247]** This is a **[*193]** suit for a preliminary injunction in which the relief sought is, as the dissenting judges below characterized it, the "mild prophylactic," *306 F.2d, at 613,* of requiring a fiduciary to disclose to his clients, not all his security holdings, but only his dealings in recommended securities just before and after the issuance of his recommendations.

n39 See cases cited in 37 C. J. S., Fraud (1943), 210.

Even in a damage suit between parties to an arm's-length transaction, the intent which must be established need not be an intent to cause injury to the client, as the courts below seem to have assumed. "It is to be noted that it is not necessary that the person making the misrepresentations intend to cause loss to the other or gain a profit for himself; it is only necessary that he intend action in reliance on the truth of his misrepresentations." 1 Harper and James, The Law of Torts (1956), 531. "The fact that the defendant was disinterested, that he had the best of motives, and that he thought he was doing the plaintiff a kindness, will not absolve him from liability so long as he did in fact intend to mislead." Prosser, Law of Torts (1955), 538. See 3 Restatement, Torts (1938), § 531, Comment *b*, illustration 3. It is clear that respondents' failure to disclose the practice here in issue was purposeful, and that they intended that action be taken in reliance on the claimed disinterestedness of the service and its exclusive concern for the clients' interests.

n40 Neither is this a criminal proceeding for "willfully" violating the Act, 54 Stat. 857, as amended, *15 U. S. C. § 80b-17,* nor a proceeding to revoke or suspend a registration "in the public interest," 54 Stat. 850, as amended, *15 U. S. C. § 80b-3.* Other considerations may be relevant in such proceedings. Compare *Federal Communications Comm'n v. American Broadcasting Co., 347 U.S. 284.*

[*HR5]** **[***HR6]** The content of common-law fraud has not remained static as the courts below seem to have assumed. It has varied, for example, with the nature of the relief sought, the relationship between the parties, and the merchandise in issue. It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages.

"Law had come to regard fraud . . . as primarily a tort, and hedged about with stringent requirements, the chief of which was a strong moral, or rather immoral element, while equity regarded it, as it had all along regarded it, as a conveniently comprehensive word for the expression of a lapse from the high standard of conscientiousness that it exacted from any party occupying a certain contractual or fiduciary relation towards another party." n41

[284]**

[*HR7]** "Fraud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element." n42

[*194]

[*HR8]** "Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another." n43

[*HR9]** **[***HR10]** **[***HR11]** Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arm's-length transaction. Courts have imposed on a fiduciary an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts," n44 as **[***248]** well as an affirmative obligation "to employ reasonable care to avoid misleading" n45 his clients. There has also been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue. n46 The 1909 New York case of *Ridgely v. Keene, 134 App. Div. 647, 119 N. Y. Supp. 451,* illustrates this continuing development. An investment adviser who, like respondents, published an investment advisory service, agreed, for compensation, to influence his clients to buy shares

in a certain security. He did not disclose the agreement to his client but sought "to excuse his conduct by asserting that . . . he honestly [*195] believed, that his subscribers would profit by his advice . . . ." The court, holding that "his belief in the soundness of his advice is wholly immaterial," declared the act in question "a palpable fraud."

n41 Hanbury, Modern Equity (8th ed., 1962), 643. See Letter of Lord Hardwicke to Lord Kames, dated June 30, 1759, printed in Parkes, History of the Court of Chancery (1828), 508, quoted in Snell, Principles of Equity (25th ed. 1960), 496:

"Fraud is infinite, and were a Court of Equity once to lay down rules, how far they would go, and no farther, in extending their relief against it, or to define strictly the species or evidence of it, the jurisdiction would be cramped, and perpetually eluded by new schemes which the fertility of man's invention would contrive."

n42 De Funiak, Handbook of Modern Equity (2d ed. 1956), 235.

n43 *Moore v. Crawford, 130 U.S. 122, 128,* quoting 1 Story, Equity Jur. § 187.

n44 Prosser, Law of Torts (1955), 534-535 (citing cases). See generally Keeton, Fraud -- Concealment and Non-Disclosure, *15 Texas L. Rev. 1.*

n45 1 Harper and James, The Law of Torts (1956), 541.

n46 See generally Shulman, Civil Liability and the Securities Act, *43 Yale L. J. 227 (1933).*

[***HR12] We cannot assume that Congress, in enacting legislation to prevent fraudulent practices by investment advisers, was unaware of these developments in the common law of fraud. Thus, even if we were to agree with the courts below that Congress had intended, in effect, to codify the common law of fraud in the Investment Advisers Act of 1940, it would be logical to conclude that Congress codified the common law "remedially" as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not "technically" as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels.

[***HR13] [***HR14] The foregoing analysis of the judicial treatment of common-law fraud reinforces our conclusion that Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit" upon a client, did not intend to require proof of intent to injure and actual injury to the client. Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation "enacted for the purpose of avoiding [**285] frauds," n47 not technically and restrictively, but flexibly to effectuate its remedial purposes.

n47 3 Sutherland, Statutory Construction (3d ed. 1943), 382 *et seq.* (citing cases). See Note, *38 N. Y. U. L. Rev. 985;* Comment, 30 U. of Chi. L. Rev. 121, 131-147.

II.

[***HR1B] We turn now to a consideration of whether the specific conduct here in issue was the type which Congress intended to reach in the Investment Advisers Act of 1940. [*196] It is arguable -- indeed it was argued by "some investment counsel representatives" who testified before the Commission -- that any "trading by investment counselors for their own account in securities in which their clients were interested . . ." n48 creates a potential conflict of interest which must be eliminated. We need not go that far in this case, since here the Commission [***249] seeks only disclosure of a conflict of interests with significantly greater potential for abuse than in the situation described above. An adviser who, like respondents, secretly trades on the market effect of his own recommendation may be motivated -- consciously or unconsciously -- to recommend a given security not because of its potential for long-run price increase (which would profit the client), but because of its potential for short-run price increase in response to anticipated activity from the recommendation (which would profit the adviser). n49 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." *United States v. Mississippi Valley Co., 364 U.S. 520, 549.* n50 Accordingly, [*197] we hold that the Investment Advisers Act of 1940 empowers the courts, upon a showing such as that made here, to require an adviser to make full

and frank disclosure of his practice of trading on the effect of his recommendations.

n48 See text accompanying note 27, *supra.*

n49 For a discussion of the effects of investment advisory service recommendations on the market price of securities, see Note, *51 Calif. L. Rev. 232, 233.*

n50 This Court, in discussing conflicts of interest, has said:

"The reason of the rule inhibiting a party who occupies confidential and fiduciary relations toward another from assuming antagonistic positions to his principal in matters involving the subject matter of the trust is sometimes said to rest in a sound public policy, but it also is justified in a recognition of the authoritative declaration that no man can serve two masters; and considering that human nature must be dealt with the rule does not stop with actual violations of such trust relations, but includes within its purpose the removal of any temptation to violate them . . .

". . . In *Hazelton v. Sheckells, 202 U.S. 71, 79,* we said: 'The objection . . . rests in their tendency, not in what was done in the particular case. . . . The court will not inquire what was done. If that should be improper it probably would be hidden and would not appear.'" *United States v. Mississippi Valley Co., 364 U.S. 520, 550, n. 14.*

III.

[*HR15] [***HR16] [***HR17] [***HR18]** Respondents offer three basic arguments against this conclusion. They argue first that Congress could have made, but did not make, failure to disclose material facts unlawful in the Investment Advisers Act of 1940, as it did in the Securities Act of 1933, n51 and that **[**286]** absent specific language, it should not be assumed that Congress intended to include failure to disclose in its general proscription of any practice which operates as a fraud or deceit. But considering the history and chronology of the statutes, this omission does not seem significant. The Securities **[*198]** Act of 1933 was the first experiment **[***250]** in federal regulation of the securities industry. It was understandable, therefore, for Congress, in declaring certain practices unlawful, to include both a general proscription against fraudulent and deceptive practices and, out of an abundance of caution, a specific proscription against nondisclosure. It soon became clear, however, that the courts, aware of the previously outlined developments in the common law of fraud, were merging the proscription against nondisclosure into the general proscription against fraud, treating the former, in effect, as one variety of the latter. For example, in *Securities & Exchange Comm'n v. Torr, 15 F.Supp. 315 (D. C. S. D. N. Y. 1936),* rev'd on other grounds, *87 F.2d 446,* Judge Patterson held that suppression of information material to an evaluation of the disinterestedness of investment advice "operated as a deceit on purchasers," *15 F.Supp., at 317.* Later cases also treated nondisclosure as one variety of fraud or deceit. n52 In light of this, and in light of the evident purpose of the Investment Advisers Act of 1940 to substitute a philosophy of disclosure for the philosophy of *caveat emptor,* we cannot assume that the omission in the 1940 Act of a specific proscription against nondisclosure was intended to limit the application of the antifraud and antideceit provisions of the Act so as to render the Commission impotent to enjoin suppression of material facts. The more reasonable assumption, considering what had transpired between 1933 and 1940, is that Congress, in enacting the Investment Advisers Act of 1940 and proscribing **[*199]** any practice which operates "as a fraud or deceit," deemed a specific proscription against nondisclosure surplusage.

n51 48 Stat. 84, as amended, *15 U. S. C. § 77q* (a), provides:

"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."

n52 See *Archer v. Securities & Exchange Comm'n, 133 F.2d 795* (C. A. 8th Cir.), cert. denied, *319 U.S. 767; Charles Hughes & Co.* v. *Securities & Exchange Comm'n, 139 F.2d 434* (C. A. 2d Cir.), cert. denied, *321 U.S. 786; Hughes v. Securities & Exchange Comm'n, 85 U. S. App. D.*

C. 56, 174 F.2d 969; Norris & Hirshberg v. Securities & Exchange Comm'n, 85 U. S. App. D. C. 268, 177 F.2d 228; Speed v. Transamerica Corp., 235 F.2d 369 (C. A. 3d Cir.).

Respondents also argue that the 1960 amendment n53 to the Investment Advisers Act of 1940 justifies a narrow interpretation of the original enactment. The amendment made two significant changes which are relevant here. "Manipulative" practices were added to the list of those specifically proscribed. There is nothing to suggest, however, that with respect to a requirement of disclosure, "manipulative" is any broader than fraudulent or deceptive. n54 Nor is there any indication that by adding the new proscription Congress intended to narrow the **[**287]** scope of the original proscription. The new amendment also authorizes the Commission "by rules and regulations [to] define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." The legislative history offers no indication, **[***251]** however, that Congress intended such rules to substitute for the "general and flexible" antifraud provisions which have long been considered necessary to control "the versatile inventions of fraud-doers." n55 Moreover, the intent of Congress must be culled from the events surrounding the passage of **[*200]** the 1940 legislation. "Opinions attributed to a Congress twenty years after the event cannot be considered evidence of the intent of the Congress of 1940." *Securities & Exchange Comm'n v. Capital Gains Research Bureau, Inc., 306 F.2d 606, 615* (dissenting opinion). See *United States v. Philadelphia Nat. Bank, 374 U.S. 321, 348-349.*

n53 74 Stat. 887, *15 U. S. C. (Supp. IV) § 80b-6* (4).

The amendment, as it is relevant here, made it unlawful for an investment adviser:

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

n54 See, *e. g.*, 48 Stat. 895, as amended, *15 U. S. C. § 78o* (c)(1), which refers to such devices "as are manipulative, deceptive, or *otherwise* fraudulent." (Emphasis added.)

n55 *Stonemets v. Head, 248 Mo. 243, 263, 154 S. W. 108, 114.* See also note 41, *supra.*

[*HR19]** **[***HR20]** **[***HR21]** Respondents argue, finally, that their advice was "honest" in the sense that they believed it was sound and did not offer it for the purpose of furthering personal pecuniary objectives. This, of course, is but another way of putting the rejected argument that the elements of technical common-law fraud -- particularly intent -- must be established before an injunction requiring disclosure may be ordered. It is the practice itself, however, with its potential for abuse, which "operates as a fraud or deceit" within the meaning of the Act when relevant information is suppressed. The Investment Advisers Act of 1940 was "directed not only at dishonor, but also at conduct that tempts dishonor." *United States v. Mississippi Valley Co., 364 U.S. 520, 549.* Failure to disclose material facts must be deemed fraud or deceit within its intended meaning, for, as the experience of the 1920's and 1930's amply reveals, the darkness and ignorance of commercial secrecy are the conditions upon which predatory practices best thrive. To impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute. Reading the Act in light of its background we find no such requirement commanded. Neither the Commission nor the courts should be required "to separate the mental urges," *Peterson v. Greenville, 373 U.S. 244, 248,* of an investment adviser, for "the motives of man are too complex **[*201]** . . . to separate . . . ." *Mosser v. Darrow, 341 U.S. 267, 271.* The statute, in recognition of the adviser's fiduciary relationship to his clients, requires that his advice be disinterested. To insure this it empowers the courts to require disclosure of material facts. It misconceives the purpose of the statute to confine its application to "dishonest" as opposed to "honest" motives. As Dean Shulman said in discussing the nature of securities transactions, what is required is "a picture not simply of the show window, but of the entire store . . . not simply truth in the statements volunteered, but disclosure." n56 The high standards of business morality exacted by our laws regulating the securities industry do not permit an investment adviser to trade on the market effect of his own recommendations without fully and fairly revealing his personal interests in **[***252]** these recommendations to his clients.

n56 Shulman, Civil Liability and the Securities Act, *43 Yale L. J. 227, 242.*

Experience has shown that disclosure in such situations, while not onerous to the adviser, is needed to preserve the **[**288]** climate of fair dealing which is so essential to maintain public confidence in the securities industry and to preserve the economic health of the country.

The judgment of the Court of Appeals is reversed and the case is remanded to the District Court for proceedings consistent with this opinion.

Reversed and remanded.

MR. JUSTICE DOUGLAS took no part in the consideration or decision of this case.

[*202] APPENDIX TO OPINION OF THE COURT.

On one occasion respondents sold short some shares of a security immediately before stating in their Report that the security was overpriced. After the publication of the Report, respondents covered their short sales.

Respondents' transactions are summarized by the Commission as follows:

Stock	Purchased	Purchase price	Recommended
Continental Insurance Co.	3/15/60	47 3/4 - 47 7/8	3/18/60
United Fruit Co	5/13, 16, 19, 20/60	21 1/4 22 1/8	5/27/60
Creole Petroleum Corp	7/5, 14/60	25 1/4 - 28 3/4	7/15/60
Hart, Schaffner & Marx	8/8/60	23	8/12/60
Union Pacific	10/28, 31/60	25 3/8 - 25 5/8	11/1/60
Frank G. Shattuck Co	10/11/60 (purchased calls)	16.83 (2.53 call cost, plus 14.30 option price)	10/14/60
Chock Full O'Nuts	10/4/60 (sold short)	68 3/4 - 69 (sale price)	10/14/60 (disparaged)

Stock	Sold	Sale price	Profit
Continental Insurance Co.	3/29/60	50 1/8	$ 1,125.00
United Fruit Co	6/6, 7, 9, 10/60	23 5/8 - 24 1/2	10,725.00
Creole Petroleum Corp	7/20, 21, 22/60	27 1/8 - 29	1,762.50
Hart, Schaffner & Marx	8/18, 22/60	24 7/8 - 25 1/4	837.00
Union Pacific	11/7/60	27	1,757.00
Frank G. Shattuck Co	10/25/60 (exercised calls and sold)	19 1/2 20 1/8	695.17
Chock Full O'Nuts	10/24/60 (covered short sale)	62 - 62 1/2 (purchase price)	2,772.33

Although some of the above figures relating to profits are disputed, respondents do not substantially contest the remaining figures.

DISSENTBY:

HARLAN

DISSENT:

[*203] MR. JUSTICE HARLAN, dissenting.

I would affirm the judgment below substantially for the reasons given by Judge Moore in his opinion for the majority of the Court of Appeals sitting *en banc, 306 F.2d 606,* and in his earlier opinion for the panel. *300 F.2d 745.* A few additional observations are in order.

Contrary to the majority, I do not read the Court of Appeals' *en banc* opinion as holding that either § 206 (1) of the Investment Advisers Act of 1940, 54 Stat. 847 (prohibiting the employment of "any device, scheme, or artifice to defraud any client or prospective client"), or § 206 (2), 54 Stat. 847 (prohibiting [***253] the engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client"), is confined by traditional common law concepts of fraud and deceit. That court recognized that "federal securities laws are to be construed broadly to effectuate their remedial purpose." *306 F.2d, at 608.* It did not hold or intimate that proof of "intent to injure and actual injury to clients" (*ante*, p. 186) was necessary to make out a case under these sections of the [**289] statute. Rather it explicitly observed: "Nor can there be any serious dispute that a relationship of trust and confidence should exist between the advisor and the advised," *ibid.*, thus recognizing that no such proof was required. In effect the Court of Appeals simply held that the terms of the statute require, at least, some proof that an investment adviser's recommendations are not disinterested.

I think it clear that what was shown here would not make out a case of fraud or breach of fiduciary relationship under the most expansive concepts of common law or equitable principles. The nondisclosed facts indicate no more than that the respondents personally profited [*204] from the foreseeable reaction to sound and impartial investment advice. n1

n1 According to respondents' brief (and the fact does not appear to be contested), the annual gross income of Capital Gains Research Bureau from publishing investment information and advice was some $ 570,000. Even accepting the S. E. C.'s figures, respondents' profit from the trading transactions in question was somewhat less than $ 20,000. Thus any basis for an inference that respondents' advice was tainted by self-interest, which might have been drawn had respondents' buying and selling activities been more significant, is lacking on this record.

The cases cited by the Court (*ante*, p. 198) are wide of the mark as even a skeletonized statement of them will show. In *Securities & Exchange Comm'n v. Torr, 15 F.Supp. 315,* reversed on other grounds, *87 F.2d 446,* defendants were in effect bribed to recommend a certain stock. Although it was not apparent that they lied in making their recommendations, it was plain that they were motivated to make them by the promise of reward. In the case before us, there is no vestige of proof that the reason for the recommendations was anything other than a belief in the soundness of the investment advice given.

Charles Hughes & Co. v. *Securities & Exchange Comm'n, 139 F.2d 434,* involved sales of stock by customers' men to those ignorant of the market value of the stocks at 16% to 41% above the over-the-counter price. Defendant's employees must have known that the customers would have refused to buy had they been aware of the actual market price.

The defendant in *Norris & Hirshberg, Inc., v. Securities & Exchange Comm'n 85 U. S. App. D. C. 268, 177 F.2d 228,* dealt in unlisted securities. Most of its customers believed that the firm was acting only on their behalf and that its income was derived from commissions; in fact the firm bought from and sold to its customers, and received its income from mark-ups and mark-downs. The nondisclosure of this basic relationship did not, the court stated, [*205] "necessarily establish that petitioner violated the antifraud provisions of the Securities and Securities Exchange Acts." *Id., at 271, 177 F.2d, at 231.* Defendant's trading practices, however, were found to establish such a [***254] violation; an example of these was the buying of shares of stock from one customer and the selling to another at a substantially higher price on the same day. The opinion explicitly distinguishes between what is necessary to prove common law fraud and the grounds under securities legislation sufficient for revocation of a broker-dealer registration. *Id., at 273, 177 F.2d, at 233.*

Arleen Hughes v. Securities & Exchange Comm'n, 85 U. S. App. D. C. 56, 174 F.2d 969, concerned the revocation of the license of a broker-dealer who also gave investment advice but failed to disclose to customers both the best price at which the securities could be bought in the open market and the price which she had paid for them. Since the court expressly relied on language in statutes and regulations making unlawful "any omission to state a material fact," *id., at 63, 174 F.2d, at*

976, this case hardly stands for the proposition that the result would have been the same had such provisions been absent.

[290]** In *Speed v. Transamerica Corp., 235 F.2d 369,* the controlling stockholder of a corporation made a public offer to buy stock, concealing from the other shareholders information known to it as an insider which indicated the real value of the stock to be considerably greater than the price set by the public offer. Had shareholders been aware of the concealment, they would undoubtedly have refused to sell; as a consequence of selling they suffered ascertainable damages.

In *Archer v. Securities & Exchange Comm'n, 133 F.2d 795,* defendant copartners of a company dealing in unlisted securities concealed the name of Claude Westfall, who was found to be in control of the business. Westfall was thereby enabled to defraud the customers of the **[*206]** brokerage firm of Harris, Upham & Co., for which he worked as a trader. Securities of the customers of the latter firm were bought by defendants' company at under the market level, and defendants' company sold securities to the clients of Harris, Upham & Co at prices above the market.

In all of these cases but *Arleen Hughes,* which turned on explicit provisions against nondisclosure, the concealment involved clearly reflected dishonest dealing that was vital to the consummation of the relevant transactions. No such factors are revealed by the record in the present case. It is apparent that the Court is able to achieve the result reached today only by construing these provisions of the Investment Advisers Act as it might a pure conflict of interest statute, cf. *United States v. Mississippi Valley Co., 364 U.S. 520,* something which this particular legislation does not purport to be.

I can find nothing in the terms of the statute or in its legislative history which lends support to the absolute rule of disclosure now established by the Court. Apart from the other factors dealt with in the two opinions of the Court of Appeals, it seems to me especially significant that Congress in enacting the Investment Advisers Act did not include the express disclosure provision found in § 17 (a)(2) of the Securities Act of 1933, 48 Stat. 84, n2 even though it did carry over to the Advisers Act the comparable fraud **[***255]** and deceit provisions of the Securities Act. n3 **[*207]** To attribute the presence of a disclosure provision in the earlier statute to an "abundance of caution" (*ante,* p. 198) and its omission in the later statute to a congressional belief that its inclusion would be "surplusage" (*ante,* p. 199) is for me a singularly unconvincing explanation of this controlling difference between the two statutes. n4

n2 That section makes it unlawful "to obtain money or property by means of . . . 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 . . . ."

n3 Section 17 (a) of the 1933 Act makes it unlawful "(1) to employ any device, scheme, or artifice to defraud . . . (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." Compare the language of these provisions with that of § 206 (1), (2) of the Investment Advisers Act, *supra,* p. 203.

n4 The argument is that by the time of enactment of the Investment Advisers Act in 1940 Congress had become aware that the courts "were merging the proscription against nondisclosure [contained in the 1933 Securities Act] into the general proscription against fraud" also found in the same act. *Ante,* p. 198. However, the only federal pre-1940 case cited is *Securities & Exchange Comm'n* v. *Torr, ante,* p. 198, and *supra,* p. 204. There the failure of a fiduciary to disclose that his advice was prompted by a "bribe" was equated by the trial judge with deceit. Such a decision can hardly be deemed to establish that *any* nondisclosure of a fact material to the recipient of investment advice is fraud or deceit. Saying the least, it strains credulity that a provision expressly proscribing material omissions would be thought by Congress to be "surplusage" when it came to enacting the 1940 Act. This is particularly so when it is remembered that violation of the fraud and deceit section is punishable criminally (§ 217 of the Investment Advisers Act of 1940, 54 Stat. 857); Congress must have known that the courts do not favor expansive constructions of criminal statutes.

However **[**291]** salutary may be thought the disclosure rule now fashioned by the Court, I can find no authority for it either in the statute or in any regulation duly promulgated thereunder by the S. E. C. Only two Terms ago we refused to extend certain provisions of the Securities Exchange Act of 1934 to encompass "policy" considerations at least as cogent as those urged here by the S. E. C. *Blau v. Lehman, 368 U.S. 403.* The Court should have exercised the same wise judicial restraint in this case. This is particularly so at this interlocutory stage of the litigation. It is conceivable that at the trial

the S. E. C. would have been able to make out a case under the statute construed according to its terms.

I respectfully dissent.

REFERENCES: Return To Full Text Opinion
Construction and application of 15 USC 80b- 6, dealing with prohibited transactions by investment advisers

Annotation References:

1. Resort to constitutional or legislative debates, committee reports, journals, etc., as aid in construction of statute. 70 ALR 5.

2. Elements essential to sustain action for deceit, generally. 29 L ed 740; 40 L ed 543.