→ Binder - Brief

75-7203

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

ABRAHAMSON, et al.,

Plaintiffs-Appellants,

v.

FLESCHNER, et al.,

Defendants-Appellees.

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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PRELIMINARY STATEMENT

This is an appeal from an order entered by the United States District Court for the Southern District of New York granting the defendants' motion for summary judgment and dismissing the complaint in an action to recover damages for alleged violations of the antifraud provisions of the Securities Exchange Act of 1934, 15 U.S.C. 78a, _et seq._, and the Investment Advisers Act of 1940, 15 U.S.C. 80b-1, _et seq._ The district court's order was based on its conclusion that plaintiffs had suffered no compensable damages.

On November 21, 1975, after receiving briefs from the parties and hearing oral argument in this appeal, this Court entered an order reserving decision on all issues pending the filing of supplemental briefs by the parties, and an _amicus curiae_ brief which it requested the Securities and Exchange Commission to file. This Court specifically asked the parties and the Commission to focus on the issues raised under the Investment Advisers Act, including whether a private right of action exists for violations of the antifraud provisions of that Act. The Securities and Exchange Commission files this brief as amicus curiae in response to this Court's request.

STATEMENT OF THE ISSUES ADDRESSED

In this brief, the Commission will address the following issues arising under the Investment Advisers Act:

(1) Where limited partners in an investment partnership entrusted the management of their money to the complete investment discretion of the general partners, were the general partners "investment advisers," as that term is defined in Section 202(a)(11) of the Investment Advisers Act of 1940, 15 U.S.C. §80b-2(a)(11)?[1/]

(2) Should a private right of action be implied for violations of the antifraud provisions of the Investment Advisers Act?

(3) Where it is alleged that the limited partners to an investment partnership agreement contemplated that the general partners would make a continuing series of investments in liquid, marketable securities, but, contrary to their contractual agreement, the general partners fraudulently placed the funds of the limited partners in

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1/ If none of the defendants herein is within the definition of the term "investment adviser," there could be no cause of action under Section 206 of the Investment Advisers Act. The Commission therefore addresses this threshold issue prior to the addressing the question whether a private right of action may be implied for violations of the Investment Advisers Act. The facts underlying this issue apparently are not in dispute to any substantial degree.

illiquid investments--

--did the district court err in concluding that the plaintiffs had suffered no damages compensable under either the Investment Advisers Act of 1940 or the Securities Exchange Act of 1934 on the basis of computations which merely aggregated the total profit made by the plaintiffs over the entire term of their investment in the partnership, the court having made no inquiry as to which, if any, of the individual transactions were affected by antifraud violations, and which, if any, of such transactions had resulted in "out-of-pocket" loss to the plaintiffs?

STATEMENT OF THE CASE

In their complaint, plaintiffs Robert and Marjorie Abrahamson allege that, during the period 1966-1970, they were limited partners in defendant Fleschner Becker Associates (FBA), an investment partnership. Complaint ¶¶ 2, 9; App. 4a-5a. 2/ In that capacity, the plaintiffs contributed funds which were pooled with the funds of other limited partners and placed under the management of the general partners, who, by the terms of the partnership agreement, had discretion to choose the investments the partnership would make. Complaint, ¶¶ 10, 12; App. 5a-6a. Defendants Malcolm K. Fleschner and William J. Becker were general partners of FBA throughout the relevant period; defendant Harold B. Ehrlich was a general partner of FBA during part of that relevant period. The remaining defendant, Harry Goodkin & Company, is a firm of certified public accountants which audited FBA's books for the fiscal years 1966, 1967 and 1968. Complaint ¶¶ 4-6, 8; App. 5a.

2/ "App. ____" refers to pages of the Joint Appendix filed in this appeal.

The plaintiffs allege that, despite defendants' representations that FBA would adhere to a conservative investment strategy and invest primarily in liquid securities, defendants concealed from plaintiffs the fact that, beginning in 1968 on, an excessive proportion of the FBA portfolio consisted of illiquid securities which were not registered with the Securities and Exchange Commission and which were subject to restrictions as to further sale. Complaint ¶ 16; App. 7a-8a. Plaintiffs claim that in 1970, when they liquidated their partnership interests in FBA upon learning of the disproportionate investment by FBA in unregistered and restricted securities,[3/] they received a substantially smaller return of capital than they would have received if they had been informed of these illiquid investments earlier and had withdrawn from the partnership at the end of an earlier fiscal year.[4/] Plaintiffs claim that this concealment by the defendants of the

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3/ Plaintiffs allege that 77% of FBA's total assets were invested in restricted securities. Complaint ¶ 17; App. 8a.

4/ Pursuant to the partnership agreement, funds could be withdrawn by limited partners only at the end of the partnership's fiscal year, and then only if 60 days' notice had been given to the general partners. Complaint, ¶ 11; App. 6a. Plaintiffs allege that they learned the true facts concerning the partnership's investment "about December, 1969 or January, 1970." Complaint, ¶ 16; App. 8a. Plaintiffs further allege that they withdrew "at the earliest possible time" thereafter, the end of the fiscal year ending September 30, 1970. Complaint, ¶¶ 18, 9; App. 8a, 5a.

The Commission does not address the issue whether the plaintiffs had a duty to mitigate their damages immediately upon learning of the alleged fraud by attempting to withdraw from the partnership immediately, or whether the contractual provision that such withdrawals could occur only at the end of a fiscal year made it reasonable to await the end of that period to take any action.

facts concerning FBA's portfolio violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), Rule 10b-5 promulgated thereunder, 17 CFR §240.10b-5, and Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. §80b-6. Plaintiffs seek damages from the defendants in the total amount of $1,254,800. Complaint, ¶ 24; App. 10a.

On March 4, 1975, the district court granted defendants' motion for summary judgment and dismissed the complaint. The court below held that, since plaintiffs had realized a net profit on their total investment in FBA, they had failed to establish that they had suffered damages cognizable under either the Securities Exchange Act or the Investment Advisers Act. App. 298a. In so holding, the district court noted that the sum of what plaintiffs withdrew from the partnership exceeded the sum of their capital contributions by $156,097.00 for Robert Abrahamson, and by $133,081.35 for Marjorie Abrahamson. App. 295a-296a.[5/]

From the judgment entered on March 27, 1975, plaintiffs have taken this appeal.

ARGUMENT

INTRODUCTION AND SUMMARY

The complaint in this action alleges a "garden type variety" securities fraud.[6/] It is alleged that the defendants--investment

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5/ As the court below noted, plaintiffs' claim of damages in excess of $1 million results from comparing what they actually received when they withdrew from FBA, and the amount they would have received had they withdrawn two fiscal years earlier, which they contend they would have done if they had known of the extent of FBA's investment in unregistered securities. App. 296a.

6/ See A. T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (C.A. 2, 1967).

advisers within the contemplation of law and common sense--induced the plaintiffs to entrust monies to them for investment, upon the explicit representation that the defendants would invest the plaintiffs' funds primarily in conservative, fully marketable securities. Instead, the defendants did just the opposite; they invested plaintiffs' funds primarily in securities which were not readily marketable.

This Court has asked the Securities and Exchange Commission to focus upon the issues raised by these facts under the Investment Advisers Act of 1940. For defendants to seek to avoid liability under that Act by urging this Court to view the definition of the term "investment adviser" as excluding them from responsibility for otherwise unlawful conduct would be to argue that the federal securities law definition be construed "technically and restrictively." This Court should conclude that the defendants who were general partners of the investment partnership were investment advisers.

Since 1946, the federal courts consistently have implied the existence of private rights of action for violations of the antifraud provisions of the federal securities laws. Kardon v. National Gypsum Co., 69 F.Supp. 512, 514 (E.D. Pa., 1946). Among the various antifraud provisions for which private rights of action have been implied are Section 10(b) of the Securities Exchange Act and the Commission's Rule 10b-5 thereunder.[7/] Section 206 of the Investment Advisers Act

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7/ The Supreme Court has noted that "[i]t is now established that a private right of action is implied under §10(b)" of the Exchange Act. Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n. 9 (1971).

is significantly similar, in general purport, to Section 10(b), and differs principally only in that (1) its coverage is limited to investment advisers, whereas Section 10(b) is applicable to "any person;" and (2) it governs fraud in connection with investment advice and, therefore, presumably does not in every case require the purchase or sale of a security, unlike Section 10(b) and Rule 10b-5, which have been held to require that the fraud involved occur in connection with such a purchase or sale. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

The ratio decidendi upon which almost thirty years of consistent judicial recognition and encouragement of private rights of action under the various antifraud provisions of the federal securities laws are predicated applies with equal force in the instant case to Section 206 of the Investment Advisers Act. This is true not only because Section 206 conforms in all respects to the general requirements for the implication of private rights of action articulated by the Supreme Court, but also because, as we argue, infra, the conduct here alleged also would appear to violate Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, and this private action undeniably could be maintained on that latter basis alone. It would indeed be anomolous, at best, for this Court to hold that the same conduct which injured the plaintiffs can violate both Section 10(b) of the Securities Exchange Act and Section 206 of the Investment

Advisers Act,[8/] but a private action will be implied only for the former violation, and not the latter.

Moreover, the Investment Advisers Act was passed in conjunction with, and as a necessary supplement to, the Investment Company Act of 1940. This Court and other courts have long implied the existence of private rights of action under the Investment Company Act. See _infra_, note 23. Sound application of existing precedent would seem to militate strongly in favor of implying an additional private right of action for the Investment Advisers Act, in order to ensure that investors may obtain the protections of the Investment Company Act not only by suing investment companies in which they invested, but the persons frequently responsible for such violations, the advisers to such companies.

Also presented on this appeal are issues with respect to the proper compensation of damages for violation of the antifraud provisions of the federal securities laws. This Court and other courts have recognized the importance of the "didactic" effects of the damages awarded for violations of those laws, _Chris-Craft Industries, Inc._ v. _Piper Aircraft Corp._, 480 F.2d 341, 395 (C.A. 2), _certiorari denied_, 414 U.S. 910 (1973). The application of a proper measure of damages is essential if the remedial purposes of the federal securities laws are not to be frustrated.

8/ See _Securities and Exchange Commission_ v. _National Securities, Inc._, 393 U.S. 453, 468 (1969), in which the Court noted that there are some situations in which the antifraud provisions of both Section 10(b) and Section 14 of the Securities Exchange Act would apply and stated: "The fact that there may well be some overlap is neither unusual nor unfortunate."

The court below held that no damages had resulted from defendants' actions by taking into consideration solely the fact that the net result of plaintiffs' four-year participation in the investment partnership did not result in a loss. The gravamen of the complaint in this action, however, is that after defendants had achieved a considerable profit, they departed from their agreement with plaintiffs and fraudulently invested over three-fourths of the partnership's assets in illiquid, unmarketable securities. Under these circumstances the district court was, we submit, required to determine which specific securities transactions were affected by the defendants' fraud and to what extent the plaintiffs suffered losses on those transactions. We agree with the district court that the "out-of-pocket" test applies here, but its proper application requires that any loss resulting from a fraudulent transaction be compensated--irrespective of whether other transactions (proper or fraudulent) may have been profitable.

Accordingly, the district court's grant of defendants' motion for summary judgment on the ground that plaintiffs suffered no damages should be reversed.

I. THE GENERAL PARTNERS OF FBA ARE INVESTMENT ADVISERS, WITHIN THE MEANING OF THE INVESTMENT ADVISERS ACT OF 1940.

The Investment Advisers Act defines the term "investment adviser" in Section 202(a)(11) as including

> ". . . 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 who, for compensation

> and as part of a regular business, issues or promulgates analyses or reports concerning securities. . . ." 9/

Defendants Fleschner, Becker and Ehrlich deny in their answers to the complaint that they fall within this statutory definition, 10/ but have not argued this point in their brief before this Court. See Brief for Appellees Malcolm K. Fleschner, William J. Becker and Fleschner Becker Associates, pp. 51-56. In their reply brief, plaintiffs assert, without extended discussion, that the general partners are investment advisers under the Act. Appellants' Reply Brief, p. 21.

Defendant FBA is a partnership the principal purpose of which was to invest and trade in securities. App. 5a. The general partners of FBA, including defendants Fleschner, Becker and Ehrlich, had the sole power to make investment decisions for the partnership. App. 6a. Thus, according to the limited partnership agreement dated October 1, 1968, which was entered into by the parties to this litigation, the general partners had power to carry out the objects and purposes of the partnership, including the power

> ". . . to invest and trade, on margin or otherwise, in capital stock, preorganization certificates and subscriptions, warrants, bonds, notes, debentures, whether subordinated, convertible or otherwise, trust receipts and other securities of whatever kind . . . and in commodities and commodities contracts. . . ." App. 89a.

9/ A number of exemptions from this definition are thereafter provided in the definition, none of which appear to be available to the defendants in this action.

10/ App. 11a, 15a.

The statutory definition of investment adviser was meant to include persons, like certain of the defendants herein, who manage the funds of others for compensation 11/ and in the process excercise complete discretion over the investments made with those funds. The Investment Advisers Act was based on a survey of investment advisers by the Securities and Exchange Commission made in connection with its study of investment trusts and investment companies. That Report, 12/ published as a supplement to the Commission's study on investment companies, noted that there were two types of services rendered by investment advisers to their clients, i.e., "discretionary" or "advisory" services. The Commission Report explained,

> "Discretionary powers imply the vesting with an investment counsel firm control over the client's funds, with the power to make the ultimate determination with respect to the sale and purchase of securities for the client's portfolio." 13/

11/ The statutory requirement of "compensation" is met in this case. As noted at p. 45 of the brief of Appellees Fleschner, Becker and FBA, the 1968 partnership agreement "authorized a $25,000 annual salary for [each of] the Managing Partners;" see paragraph 201 of the 1968 partnership agreement, App. 90a. In addition, it appears that the general partners were compensated by receiving 20% of any "net operating profits" or "net capital gains" realized by the partnership during its fiscal year. App. 93a-94a. Appellee's statement that the "salaries" paid to managing partners amounted to "only .0016" of FBA's total assets apparently does not take into account the compensation generated by this profit and capital gains sharing provision.

12/ Securities and Exchange Commission, "Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services," H. Doc. No. 477, 76th Cong., 2d Sess. (1939) [hereinafter "Commission Report"].

13/ Commission Report at 13. "Advisory" powers, by contrast, empowered an adviser merely to "make recommendations to its client, with whom rests the ultimate power to accept or reject such

(footnote continued)

In enacting legislation designed to provide a "solution of the problems and abuses of investment advisory services," Congress meant to include within the scope of its regulatory scheme advisers exercising either type of power, discretionary or advisory. As the Senate Report noted, the legislation, to be effective, had to reach "individuals and companies which either handle pools of liquid funds of the public or give advice with respect to security transactions. . . ." S. Rep. No. 1775, 76th Cong., 3d Sess., p. 21 (1940). Similarly, the House Report noted the need to regulate those who "managed, supervised, and gave investment advice with respect to funds." H.R. Rep. No. 2639, 76th Cong., 3d Sess., p. 27 (1940).[14/]

(footnote continued)

recommendations." Id. It is, of course, logical to assume that an adviser with discretionary powers who purchases a security for the account of his client has made a positive recommendation with respect to that security.

14/ A further indication that Congress intended to include both advisory and discretionary services within the regulatory scheme established by the Investment Advisers Act appears in Section 205 of the Act. This section, as in effect during the period in question, establishes certain standards and prohibitions with respect to contracts for investment advisory services, and defines the term "investment advisory contract" as "any contract or agreement whereby a person agrees to act as investment adviser or to manage any investment or trading account of another person other than" a registered investment company. 15 U.S.C. §80b-5 (emphasis added).

II. A PRIVATE CIVIL ACTION MAY BE MAINTAINED FOR VIOLATION OF THE ANTIFRAUD PROVISIONS OF THE INVESTMENT ADVISERS ACT OF 1940.

In J. I. Case Co. v. Borak, 377 U.S. 426 (1964), the Supreme Court, holding that a private right of action exists for violations of the antifraud provisions of Section 14 of the Securities Exchange Act of 1934, stated that while the legislative history of that Section makes no specific reference to a private right of action, "among its chief purposes is 'the protection of investors' which certainly implies the availability of judicial relief, where necessary to achieve that result." (emphasis added). So too, the unequivocal statement by Congress, pointed to in Securities and Exchange Commission v. Capital Gains Research Bureau, 375 U.S. at 189, demonstrates that the purpose of the Investment Advisers Act is to eliminate abuses by investment advisers conducting a business in a way which would "mislead investors, or . . . enable . . . advisers to relieve themselves of their fiduciary obligations to their clients," a purpose in accordance with which all the provisions of the Act should be interpreted.

More recently, the Supreme Court has stated that in determining whether a private remedy may be implied from a statute not expressly providing one, the following factors are "relevant:" 15/

15/ See Cort v. Ash, 422 U.S. 66, 78 (1975). The Cort case held that no private right of action may be implied from the Federal Election Campaign Act, 18 U.S.C. §610, which made it a criminal offense for a corporation to make contributions or expenditures in connection with federal elections. This statute, the Court noted, had

(footnote continued)

(1) Whether the plaintiff is "one of the class for whose especial benefit the statute was enacted," Texas & Pacific R. Co. v. Rigsby, 241 U.S. 33, 39 (1916).

(2) Whether there is any indication of legislative intent, explicit or implicit, to create such a remedy. See, *e.g.*, National Railroad Passenger Corp. v. National Ass'n. of Railroad Passengers, 414 U.S. 453, 458, 460 (1974).

(3) Whether it is consistent with the underlying purpose of the legislative scheme to imply such a remedy for the plaintiff. See, *e.g.*, Securities Investor Protection Corp. v. Barbour, 421 U.S. 412, 418-420 (1975); Calhoon v. Harvey, 379 U.S. 134 (1964).

(4) Whether the cause of action is one traditionally relegated to state law, in an area basically the concern of the states, so that it would be inappropriate to infer a cause of action based on federal law. See Wheeldin v. Wheeler, 373 U.S. 647, 652 (1963).

(footnote continued)

as its primary purpose to assure that federal campaigns are "free from the power of money," and was not directly concerned with the internal relations between corporations and their shareholders. *Id.* at 82. This case, however, was sharply distinguished by the Supreme Court from J. I. Case Co., since only the latter involved a statute which established "a pervasive legislative scheme governing the relationship between the plaintiff class and the defendant class in a particular regard," *Id.* The Investment Advisers Act, of course, established a similarly pervasive scheme governing the relationship between investment advisers and their clients. See *infra*, pp. 13-15.

While each of these four considerations is not a prerequisite to an implied right of action, but only a "factor" to be taken into consideration, we believe that an implied right of action under the Investment Advisers Act of 1940 fully satisfies each of the criteria enumerated by the Supreme Court.

A. Plaintiffs are Members of the Class for whose Especial Benefit the Investment Advisers Act was Enacted.

There is a strong presumption that the beneficiaries of a statutory provision may enlist the aid of the courts to obtain redress for any violation of the statutory provision designed for their benefit; and it would appear that the plaintiffs in this case belong to the class which the Investment Advisers Act of 1940 was intended to protect. The Investment Advisers Act had as its specific objective "to protect the public and investors against malpractices by persons advising others about securities." 16/ It "reflects a Congressional recognition 'of

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16/ Significantly, the legislative history of the Act, analyzed in Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-195 (1963), emphasizes the importance of sound advice from investment advisers. This court has recognized that the function of an investment adviser is "an occupation which can cause havoc unless engaged in by those with appropriate background and standards," Marketlines v. Securities and Exchange Commission, 384 F.2d 264, 267 (C.A. 2, 1967). And the Commission has noted:

> "The dissemination of investment advice prepared irresponsibly or recklessly in violation of this duty, not only operates as a fraud on the clients of the investment adviser but, as pointed out in the Report of the Special Study of the Securities Markets, such investment advice can generate a chain reaction of market interest resulting in severe losses for many investors."

Anne Caseley Robin d/b/a The Profitmaker, 41 SEC 634, 637 (1963), CCH Fed. Sec. L. Rep. ¶ 76,933, citing H. Doc. No. 95, pt. 1, 88th Cong., 1st Sess. (1963), p. 383.

the delicate fiduciary nature of an investment advisory relationship.'" Securities and Exchange Commission v. Capital Gains Research Bureau, supra, 375 U.S. at 180, 191. As noted by the Senate Committee which considered this legislation:

> "The nature of the functions of investment advisers, their increasing widespread activities, their potential influence on security markets and the dangerous potentialities of stock market tipsters imposing upon unsophisticated investors, convinces this Committee that protection of investors requires regulation of investment advisers on a national scale." 17/

The Investment Advisers Act therefore was designed to provide a regulatory scheme for persons engaged for compensation in the business of advising others with respect to securities transactions or exercising discretionary control over the funds of others. The Act provides generally for the registration of investment advisers, and empowers the Commission, after notice and opportunity for hearing, to deny or revoke the registration of any adviser who has been convicted or enjoined because of misconduct in respect of securities transactions, or who has willfully made an untrue statement of a material fact or omitted to report a material fact in his application for registration. 18/ And the antifraud provisions of Section 206 of the Act, 15 U.S.C. §80b-6, prohibit an investment adviser from, inter alia,

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17/ S. Rep. No. 1775, 76th Cong., 3d Sess., p. 21 (1940).

18/ Sections 203(a) and (e), 15 U.S.C. §§80b-3(a) and (e).

employing "any device, scheme or artifice" to defraud clients or prospective clients or from engaging in "any transaction, practice, or course of business which operates as a fraud" upon them.[19/]

The purpose of Section 206 of the Investment Advisers Act is, we submit, substantially similar to the purpose of Section 14(a) of the Securities Exchange Act, governing proxy solicitations. In unanamimously holding that an implied right of action exists for violations of Section 14(a) of the Securities Exchange Act, the Supreme Court noted in J. I. Case Co. v. Borak, supra, 377 U.S. at 431 (1964), that "[t]he purpose of §14(a)," is "to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation." The Court further stated that since the purpose of Section 14 of the Securities Exchange Act is "the protection of investors," the plaintiffs therein were squarely within the protected class, 377 U.S. at 432. The plaintiffs herein are no less within the class protected by the antifraud provisions of the Investment Advisers Act.

19/ 15 U.S.C. §80b-6(1) and (2). Subsection (3) prohibits an investment adviser from acting in certain capacities without disclosure to the client of his interests, and subsection (4) authorizes the Commission to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative." 15 U.S.C. §80-b(3) and (4). Pursuant to this statutory authority, the Commission has promulgated Rule 206(4)-1 under the Act, 17 CFR 275.206(4)-1, regulating advertising disseminated by investment advisers.

B. The Clear Purpose of the Antifraud Provisions of the Investment Advisers Act Implies the Existence of a Private Right of Action for Violations of Those Provisions.

As noted, supra, in J. I. Case Co. v. Borak, supra, 377 U.S. 432, the Supreme Court stated that the fact that the chief purpose of Section 14 of the Securities Exchange Act is the protection of investors "certainly implies the availability of judicial relief, where necessary to achieve that result." The difference between the jurisdictional provisions of the Investment Advisers Act and the other federal securities laws does not negate this implication.[20/] Section 214 of the Investment Advisers Act, 15 U.S.C. §§80b-14, like the comparable sections of the other federal securities statutes,[21/] reposes in the district courts of the

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20/ In requesting the submission of a brief amicus curiae by the Commission, this Court specifically asked the Commission to consider the difference between the jurisdictional provisions of the Investment Advisers Act and the other federal securities statutes.

21/ See Section 22 of the Securities Act of 1933, 15 U.S.C. §77v; Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. §78aa; Section 25 of the Public Utility Holding Company Act of 1935, 15 U.S.C. §79y; Section 322 of the Trust Indenture Act of 1939, 15 U.S.C. 77vvv; and Section 44 of the Investment Company Act of 1940, 15 U.S.C. §80a-43.

United States "jurisdiction of violations of [the Act] or the rules, regulations, or orders thereunder," and it grants concurrent jurisdiction to state and territorial courts over suits in equity to enjoin any violations of the statute.[22/] Omitted from Section 214 is any grant to district courts of jurisdiction over "actions at law brought to enforce any liability or duty created by" the statute, a provision found in the jurisdictional provisions of the other federal securities laws.

The reason for this omission is quite simple, we believe, and involves nothing more than a matter of technical draftsmanship. Addressing the argument that Section 214 of the Advisers Act precluded the implication of a private remedy at law, as distinct from equitable relief, the district court in Bolger v. Laventhol, Krekstein, Horwath & Horwath, 381 F.Supp. 260, 264-265 (S.D.N.Y., 1974), held that since each of the statutes administered by the Commission, except the Investment Advisers Act, contains one or more sections expressly granting to injured persons a right to bring suit under the statute against

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22/ Section 27 of the Securities Exchange Act is unique in that it provides for "exclusive" jurisdiction over violations of that statute in the federal courts.

the wrongdoer,[23/] the inclusion of the language in question in the jurisdictional provisions of the Investment Advisers Act was inappropriate and unnecessary and its absence did not imply Congressional intent to withhold jurisdiction over implied remedies at law.[24/]

23/ See Sections 11 and 12 of the Securities Act of 1933, 15 U.S.C. §§77k and 77l; Sections 9(e), 16(b), and 18 of the Securities Exchange Act, 15 U.S.C. §§78i(e), 78p(b), and 78r; Sections 16(a) and 17(b) of the Public Utility Holding Company Act of 1935, 15 U.S.C. §§79p(a) and 79q(b); Section 323(a) of the Trust Indenture Act of 1939, 15 U.S.C. §77www(a); and Section 30(f) of the Investment Company Act of 1940, 15 U.S.C. §80b-30(f).

It has been recognized by many courts, including this Court, that an implied right of action exists for violations of other sections of the Investment Company Act. See, e.g., Brown v. Bullock, 294 F.2d 415, 420-421 (C.A. 2, 1961); Moses v. Burgin, 445 F.2d 369 (C.A. 1), certiorari denied, 404 U.S. 994 (1971); Herpich v. Wallace, 430 F.2d 792, 815 (C.A. 5, 1970), Esplin v. Hirschi, 402 F.2d 94, 103 (C.A. 10, 1968), certiorari denied, 394 U.S. 928 (1969); Taussig v. Wellington Fund, Inc., 313 F.2d 472, 476 (C.A. 3), certiorari denied, 374 U.S. 806 (1963). It would truly create what the court below, in another context, termed an "unfortunate dichotomy" between two securities laws enacted at the same time, if there were no implied right of action under the Investment Advisers Act, in the absence of any indication by Congress that it intended such radically differing results.

24/ Neither the hearings nor the reports of the committees which considered the bills which were the forerunners of the Investment Advisers Act discussed any reason for the omission of this phrase. As originally introduced in the Senate, the Investment Advisers Act provided that the jurisdictional provisions of the Investment Company Act should be "incorporated in this title as though fully set forth herein." S. 3580, Section 206, 76th Cong., 3d Sess. The Investment Company Act of 1940 comprised Title I of S. 3580 while the Investment Advisers Act was set forth in Title II. The Investment Company Act, in turn, adopted the same jurisdictional provisions as contained in the Public Utility Holding Company Act of 1935, 15 U.S.C. §79y. S. 3580, Section 40(a)(1), 76th Cong., 3d Sess. A bill was introduced in the House at the same time with identical jurisdictional provisions. H.R. 8935, Sections 40(a), 203, 76th Cong., 3d Sess.

As reported out of Committee, the Senate bill was amended to eliminate the references in the jurisdictional provisions of

(footnote continued)

That the absence of this phrase does not preclude the implication of private rights of action under the Investment Advisers Acts is clear from the Supreme Court's analysis in J. I. Case Co. v. Borak, supra, which indicates that such rights of action are implied not primarily by a jurisdictional section, but by the substantive provisions of the statute.[25/] That was also the nature of the analysis of the district court in Angelakis v. Churchill Management Corp., CCH

(footnote continued)

the Investment Company and Investment Adviser Acts to other statutes, and the provision inserted in the Investment Advisers Act did not contain any reference to "actions at law brought to enforce any liability or duty created by" that Act. S. 4108, Section 214, 76th Cong., 3d Sess. Although the Committee filed a Report analyzing the provisions of the bill, its only comment upon the jurisdictional provision of the Investment Advisers Act was that no significant difference between that provision and the jurisdictional provision of the Investment Company Act was intended. Thus, referring to all of the provisions of the Investment Advisers Act dealing with what it called "unlawful representations, administrative and enforcement machinery and formal provisions," the Senate Report stated that the Act "contains provisions generally comparable to those of" the Investment Company Act. S. Rep. No. 1775, 76th Cong., 3d Sess., p. 23 (1940). The Report of the House Committee on Interstate and Foreign Commerce used substantially the same language as the Senate Report in describing and discussing these same provisions of a bill, H.R. 10065, 76th Cong., 3d Sess., which were identical to those contained in the Senate bill. See H. Rep. No. 2639, 76th Cong., 3d Sess., p. 30 (1940).

25/ Indeed, private rights of action have been inferred from statutes having no separate jurisdictional section. See Texas & Pacific Ry. Co. v. Rigsby, supra, 214 U.S. at 37; Narramore v. Cleveland, C.C. & St. L. Ry. Co., supra, 96 F. at 300; Odell v. Humble Oil & Refining Co., supra, 201 F.2d at 126.

Fed. Sec. L. Rep. ¶ 95,285 (N.D. Cal., 1975), which concluded that a private right of action existed under the Investment Advisers Act. That court properly considered the "conduct condemned by the statute," the "protection intended by the legislature," and the "ineffectiveness of existing remedies, administrative and judicial, to achieve them." CCH Fed. Sec. L. Rep. at p. 98464. It also took into account the jurisdictional provision of the Investment Advisers Act which, the court noted, "gives the court broad jurisdiction over '. . . violations of this subchapter or the rules, regulations, or orders thereunder. . . .'" Id. The court correctly concluded that this jurisdictional provision, far from counteracting the strong implication that there is a private right of action for violations of the antifraud provisions of the Act, is entirely sufficient to fashion a remedy for such violations. Cf., J. I. Case Co. v. Borak, 377 U.S. at 433.[26/]

26/ On December 18, 1975, the Commission announced that it had submitted legislative proposals to the Congress which would amend the Investment Advisers Act of 1940 in several ways. One of these proposals was that the Congress "clarify the existence of a private right of action based on a violation of the [Investment Advisers] Act." See Investment Advisers Act Release No. 491, 8 SEC Docket 744 (December 15, 1975). That the Commission is seeking clarification of the private right of action in order to put an end to the confusion which presently exists with respect to this issue, cf., e.g., Bolger v. Laventhal, Krekstein, Horwath & Horwath, 381 F.Supp. 260 (S.D.N.Y., 1974) with Gammage v. Roberts, Scott & Co., CCH Fed. Sec. L. Rep. ¶ 94,761 (S.D. Cal., 1974), can in no way be construed as indicating that a private right of action cannot be implied from the present statutory provisions.

We believe that this is a correct interpretation. As the Supreme Court has held, the Investment Advisers Act must, in accord with Congress' intention, "be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes." Securities and Exchange Commission v. Capital Gains Research Bureau, supra, 375 U.S. at 195 (footnote omitted).[27/] To insist upon an *explicit* jurisdictional provision for an *implicit* private right of action would, we submit, be the very antithesis of that flexible construction which the Investment Advisers Act should be afforded.

C. A Private Right of Action is Consistent with the Underlying Purposes of the Legislative Scheme.

In Securities Investor Protection Corp. v. Barbour, 421 U.S. 412 (1975), the Supreme Court held that a customer of a stockbroker (or his representative) had no private right of action under Section 7(b) of the Securities Investor Protection Act of 1970 ("SIPA"), 15 U.S.C. §78ggg(b), which expressly authorizes this Commission to apply to a United States district court "for an order requiring SIPC to discharge its obligations under" SIPA, in the event that SIPC refuses to commit its funds or otherwise to act for the protection of the

27/ As this Court noted in Shapiro v. Merrill Lynch, Pierce Fenner & Smith, Inc., 495 F.2d 228, 235 (1974), "[t]his policy of flexible, non-technical construction of the securities laws has provided the underpinning for the results in recent cases involving specific violations of the antifraud provisions of the securities laws."

customers of any broker-dealer which was a member of SIPC. 28/ Plaintiff in that action, a court-appointed receiver of a registered broker-dealer, brought suit under this statutory provision, asking that the Commission and SIPC be ordered to show cause why SIPC should not be required to intervene in the action and extend the protections of SIPA to the customers of the brokerage firm.

The Court held that the overall structure and purpose of the legislative scheme involved in that case was incompatible with an implied right of action because a private party such as the customer of a broker-dealer would rarely consider the public interest in determining whether to bring an action to compel proceedings under SIPA. For this reason, the Court noted, Congress put SIPC in the hands of a public board of directors, responsible to an agency experienced in the regulation of the securities markets. The Commission was, therefore, specifically empowered by Congress to do exactly that which the private plaintiff was attempting to do--a situation radically different from the instant case. 29/ Here, if the plaintiffs cannot maintain an action to recover

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28/ Under the Securities Investor Protection Act, SIPC may apply to a court for a decree initiating liquidation proceedings if it determines that a member has failed or is in danger of failing to meet its obligations to its customers and that one or more specific conditions exists. 15 U.S.C. 78eee(a)(2). If the application is granted, SIPC is obligated, if necessary, to advance moneys to meet certain customer claims from a fund established and maintained by required contributions from its members. 15 U.S.C. 78fff(f).

29/ A similar factual situation was present in National Railroad Passenger Corp. v. National Association of Railroad Passengers, 414 U.S. 453 (1974), on which the Court strongly relied in Barbour, see 421 U.S. at 420. There, the plaintiffs had sued to enjoin the discontinuance of a particular service as announced

(footnote continued)

damages they may have suffered, neither this Commission nor any other governmental agency will do so on their behalf.

The Supreme Court had no difficulty in differentiating between Barbour and J. I. Case Co. v. Borak, supra, stating: "We need not pause over the distinctions." 421 U.S. at 423. In J.I. Case Co., "the Court agreed with the SEC that private enforcement of the proxy rules was a necessary supplement to SEC enforcement," rather than an interference. Id. at 424. Thus, while the Investment Advisers Act and SIPC are similar in that "Congress' primary purpose in enacting the SIPA and creating SIPC was, of course, the protection of investors," id. at 421, the Commission opposed recognition of the private right of action asserted in Barbour because an implied right of action under SIPC would not promote that goal. And the Supreme Court agreed that suits by investors "who deem themselves to be in need of [SIPA's] protection" were not "capable of furthering that purpose." Id.

Unlike Barbour, however, the statute involved here is an antifraud statute, designed to protect and benefit directly a segment of the

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(footnote continued)

by the National Railroad Passenger Corporation (Amtrak) pursuant to its authority under the Rail Passenger Service Act. The Court noted, however, that the statute

> ". . . made express provision for suits against Amtrak to enforce its duties and obligations only 'upon petition of the Attorney General of the United States or, in a case involving a labor agreement, upon petition of any employee affected' by the agreement. 45 U.S.C. §547(a)."

421 U.S. at 418-419.

investing public, the clients of investment advisers, like the proxy-regulating statute in J. I. Case Co. v. Borak, supra. In that case, the Court observed that

> ". . . it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose."

377 U.S. at 433. The Commission believes that the existence of implied rights of action under such provisions as Sections 14(a) and 10(b) of the Securities Exchange Act has promoted the goals of that statute and has not interfered with the legislative scheme in any way. On the contrary, such actions are, indeed, a "necessary supplement to Commission action" taken to enforce the law, since the Commission's limited resources make impossible the detection and prosecution of every violation of these provisions. It was undoubtedly considerations such as these that led this Court to conclude that "vigorous enforcement of the federal securities laws, particularly the antifraud provisions, can be accomplished effectively only when implemented by private damage actions." Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 356 (C.A. 2), certiorari denied, 414 U.S. 910 (1973) (emphasis added). For the same reasons, an implied right of action under Section 206 of the Investment Advisers Act will not interfere with the Commission's administration of that Act; indeed, it will provide a useful and a needed supplement to Commission action.

D. The Cause of Action Asserted by Plaintiffs is One Arising Under Federal Law.

Section 201 of the Investment Advisers Act makes clear that the problems associated with investment advisory services are problems affected with a national public interest, requiring federal regulation. Remedies under state statutes vary, and cannot reasonably be expected to serve the purpose for which this federal statute was enacted. 30/ Moreover, as the Supreme Court pointed out in Securities and Exchange Commission v. Capital Gains Research Bureau, supra, 375 U.S. at 192-193, it cannot be assumed that the remedy provided by the antifraud provisions of the Investment Advisers Act is equivalent to a right of action for fraud under the common law. In rejecting decisions of the lower courts that held that the words "fraud" and "deceit" are used in the Investment Advisers Act of 1940 "in their technical sense", 31/ the Court expressed its agreement with the four dissenting judges of this Court who had pointed out that "[t]he common-law doctrines of fraud and deceit grew up in a business climate very different from that involved in the sale of securities," 306 F.2d at 614.

30/ See 1 Loss, Securities Regulation 42 (2d ed., 1961), surveying the "assorted antifraud provisions" relating to investment advisers enacted in the states. See also 4 Loss, Securities Regulation 2216 (Supp. 2d ed., 1969).

31/ Securities and Exchange Commission v. Capital Gains Research Bureau, 191 F.Supp. 897 (S.D.N.Y.), affirmed, 300 F.2d 745 (C.A. 2, 1961), affirmed on rehearing, 306 F.2d 606 (C.A. 2, 1962) (en banc), reversed, 375 U.S. 180 (1963).

The Supreme Court explained that the "content of common-law fraud has not remained static as the courts below seem to have assumed," but has varied with such considerations as "the nature of the relief sought, the relationship of the parties, and the merchandise in issue." Id. at 193. The Court concluded, id. at 145, that

> ". . . 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." (emphasis added).

While the Court in Capital Gains Research Bureau was concerned particularly with the burden the Commission had to meet in order to obtain injunctive relief prohibiting further violations of the law,[32/] much of what the Court said in that case is equally applicable to a private action for damages. For one thing, as the Court noted, it is not 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 arms-length transaction." Id. at 194. Fiduciaries are burdened with "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts' as well as an affirmative obligation 'to employ reasonable care to avoid misleading'

32/ Thus, the Court's observation that the Commission is not required, to obtain an injunction, to demonstrate "actual injury to clients," 375 U.S. at 192, would clearly have no application in a private action against an investment adviser by his client.

his clients." Id. (footnotes omitted).[33/] Secondly, it has also been recognized that the common-law doctrines of fraud and deceit as they relate to transactions involving land and other tangible items and consumer goods are "ill-suited to the sale of such intangibles as advice and securities and that, accordingly, the doctrines must be adopted to the merchandise in issue." Id. (footnote omitted). As the Commission noted in Stanford Investment Management, Inc., 43 SEC 864, 867 (1968), CCH Fed. Sec. L. Rep. ¶ 77,428,

> ". . . sales practices which may or may not be suitable for products which are subject to actual inspection and testing in use clearly have no place in the sale of securities, which are goods of an intricate, complicated and intangible nature."[34/]

33/ The Commission explained in an administrative proceeding brought against an investment adviser that

> "By the securities acts Congress sought to protect those who do not know . . . from the overreachings of 'those who do.' To attain that objective, persons engaged in the securities business must be held to rigorous standards of full and fair disclosure in their dealings with investors."

Spear & Staff, Inc., 42 SEC 549, 553 (1965), CCH Fed. Sec. L. Rep. ¶ 77, 216.

34/ Cf. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 744-745 (1975), where the Supreme Court concluded that while a claim under the antifraud provisions of Rule 10b-5 "certainly has some relationship" to an action based on the common law, "the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable." The Court then contrasted a situation involving face-to-face negotiations and representations with the impersonal nature of a typical modern securities transaction.

(footnote continued)

Plaintiffs herein are asserting a federal cause of action that is not necessarily equivalent to any cause of action they may have based on principles of common law fraud. Violations of the provisions of the Investment Advisers Act are matters which the Congress deemed detrimental to the national public interest. The objectives of that legislation--including the goal of eliminating "any . . . practice . . . which operates as a fraud or deceit upon any client"--can best be

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(footnote continued)

In Chris-Craft Industries, Inc. v. Piper Aircraft Corp., supra, 480 F.2d at 356-357, this Court had taken note of the "many salutary developments in the securities fraud area, including a broadening of standing to sue and a relaxation of the elements of proof in a private action. The court concluded, after considering the "indispensibility of private actions in the securities area," that

> "Congress and the courts justifiably have outlawed all unfair and deceptive practices related to the trading of securities and have encouraged private damage actions to implement the enforcement of the federal securities laws."

It should be noted, however, that the claim asserted by plaintiffs herein is not one that would test the outer limits of the cause of action created by the antifraud provisions of the federal securities laws. This case does not involve difficult questions of the proper standard of care or a fraud affecting the market for securities in which the plaintiffs bought without direct contact with the defendants. Rather, it involves a face-to-face relationship, a specific agreement, and an alleged breach of contract. Of course, the fact that plaintiffs may have a cause of action based on common law in no way bars the assertion of a federal remedy which subsumes and goes beyond the common law remedy.

achieved if a private right of action is implied for violations of its antifraud provisions.

* * *

No rational basis exists for denying an implied private right of action under the antifraud provisions of the Investment Advisers Act while allowing such rights under each of the similar statutes designed to protect investors. Rather, the same reasons which lead to the conclusion that private rights of action arise from the substantive provisions of the other securities statutes are equally applicable here. Nothing less will accomplish the legislative purpose of discouraging investment advisers from acting in violation of the Investment Advisers Act; and nothing would be more conducive to making the Investment Advisers Act "reasonably complete and effective." 35/

III. THE COURT BELOW IMPROPERLY APPLIED THE "OUT-OF-POCKET" TEST FOR MEASURING DAMAGES RESULTING FROM VIOLATIONS OF THE ANTIFRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS.

As noted supra, p. 5, the district court dismissed the complaint in this action because it held that the proper measure of damages in a cause of action arising from violations of Rule 10b-5 is the plaintiffs' "out-of-pocket" loss 36/ and that under that test the plaintiffs herein had suffered no loss. App. 304a-314a. The court further held, apparently assuming arguendo that there was an implied right of action under the Investment Advisers Act, that the

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35/ Fratt v. Robinson, 203 F.2d 627, 632 (C.A. 9, 1953) (with respect to an implied right of action under Section 10(b) of the Securities Exchange Act and Rule 10b-5).

36/ The "out-of-pocket" rule derives from the measure applied by the federal courts in common law fraud cases "under the 'general' laws regime of Swift v. Tyson." Levine v. Seilon, Inc., 439 F.2d 328, 334 (C.A. 2, 1971).

measure of damages under that Act would be the same. App. 315a-316a.[37/] In so holding, the court agreed with defendants' contention that, rather than suffering any losses, plaintiffs had profited considerably from their investment in FBA.[38/]

In asserting damages in excess of $1 million, on the other hand, the plaintiffs have advanced a theory which would allow recovery for the difference between the total value of their proportionate interest in the partnership assets, on paper, in 1968 and the value they received when they withdrew in September 1970. They argue that the renewal of their partnership agreement in 1968 in a modified

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37/ Section 28(a) of the Securities Exchange Act precludes the recovery, in an action under the Act, of an amount in excess of plaintiffs' actual damages on account of the Act complained of. Plaintiffs had argued that the fact that the Investment Advisers Act contains no provision comparable to Section 28(a) meant that they were not limited, in a cause of action under the Advisers Act, to "out-of-pocket" losses. The district court rejected this argument, stating that such an inconsistency would create an "unfortunate dichotomy" between the two acts. App. 316a. We believe the district court was correct in that regard. The absence from the Advisers Act of a provision similar to Section 28(a) is explained, like the difference between the jurisdictional provisions of that Act and the other securities statutes, by the absence from the Act of any explicit provision for a private right of action. While there may be circumstances in which damages resulting from a cause of action cognizable under the antifraud provisions of both the Securities Exchange Act and the Investment Advisers Act should be computed differently under the two statutes, there will normally be no reason why such a difference should exist where the fraud of an adviser concerns the purchase or sale of a security.

38/ The court found that plaintiff Robert Abrahamson contributed $150,000 in 1965 and received withdrawals at the end of various fiscal years totaling $306,097. Plaintiff Marjorie Abrahamson made capital contributions at various times totaling $449,499.35, and withdrew $585,580.70. The court agreed with defendants' argument that plaintiffs have jointly profited over the entire period of time in which they were limited partners of FBA.

form was the "purchase" of a security for purposes of Rule 10b-5 and that defendants' alleged fraud occurred "in connection with" that purchase.[39/]

While agreeing that the "out-of-pocket" test is proper in the circumstances of this case, the Commission believes that the court below improperly applied that test.[40/] Moreover, we submit, neither

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39/ With respect to the cause of action asserted under Rule 10b-5, the defendants contest whether the fraud alleged was "in connection with" the purchase or sale of any security. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). If the factual allegations of the complaint are analyzed in terms of the many securities transactions that occurred, and not merely the plaintiffs' entry into and withdrawal from the partnership, it appears that the "in connection with" test is satisfied. For this reason, the Commission does not discuss at length the issue whether a cause of action based on the antifraud provisions of the Investment Advisers Act requires a showing that the alleged fraud was "in connection with" the purchase or sale of a security, in the absence of this particular language in Section 206 of that Act. It should be noted, however, that while the principal focus of the Securities Exchange Act is the trading of securities and the relationship between a shareholder and his corporation, the principal focus of the Investment Advisers Act is the relationship between an adviser and his client. We believe, therefore, that the antifraud provisions of the Investment Advisers Act were meant to reach situations involving fraud which was not "in connection with" the purchase or sale of a security but was related to the investment advice rendered. Thus, the Investment Advisers Act could cover, for example, advice to hold and not sell a security if the advice was affected by fraud on the part of the adviser.

40/ The "out-of-pocket" test for damages is a "rule" which has been applied differently by the courts, often without a clear indication of the reason for the difference. In some cases, the courts have held that the proper measure is the difference between what a defrauded purchaser pays, or a defrauded seller receives, and the true fair market value of the stock at the time of the transaction. Affiliated Ute Citizens v. United States, 406 U.S. 128, 154-155 (1972); Fershtman v. Schectman, 450 F. 2d 1357 (C.A. 2), certiorari denied, 405 U.S. 1066 (1972); Levine v. Seilon, Inc., 439 F.2d 328 (C.A. 2, 1971). This rule may be more appropriate in defrauded seller cases, since such persons do not continue to bear the

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party has correctly stated the method for measuring any damages that may have resulted in the circumstances of this case.[41]

(footnote continued)

risks of securities they would perhaps not have purchased but for the fraud. In other cases, the "out-of-pocket" loss will equal the difference between the price a defrauded buyer pays or a defrauded seller receives and the price of the stock on the date the fraud is discovered or, in the exercise of reasonable care, should have been discovered. Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (C.A. 10), certiorari denied, 404 U.S. 1004 (1971), Esplin v. Hirschi, 402 F.2d 94, 104 (C.A. 10, 1968), certiorari denied, 394 U.S. 928 (1969). If a defrauded purchaser subsequently resells his stock before he becomes aware of the fraud, his damages are the difference in his purchase price and the price he receives on the subsequent resale. Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1173 (C.A. 2, 1970). In certain circumstances, a defrauded seller may be entitled not only to the difference between the selling price and the fair market value of the stock, but to any profit subsequently made by the buyer or to any "windfall" he may have received. Affiliated Ute Citizens v. United States, 406 U.S. 128, 154-155 (1972); Myzel v. Fields, 386 F.2d 718, 748 (C.A. 8, 1967), certiorari denied, 390 U.S. 951 (1968); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (C.A. 2, 1973); Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (C.A. 3, 1973). Finally, some courts have applied a so-called "rescission" measure of damages which allows the plaintiff the difference between the value of the securities at the time of the trial and the consideration paid by or to the plaintiff. Janigen v. Taylor, 344 F.2d 781 (C.A. 1), certiorari denied, 382 U.S. 879 (1965); Gottlieb v. Sandia American Corp., 304 F.Supp. 980 (E.D. Pa., 1969), affirmed, 452 F.2d 510 (C.A. 3), certiorari denied, 404 U.S. 938 (1971); Speed v. Transamerica Corp., 135 F.Supp. 176, 186-194 (D. Del., 1955), modified on another point and affirmed, 235 F.2d 369 (C.A. 3, 1956).

The measure employed has thus depended upon a variety of factors, including the nature of the fraud, the status of the parties to the transaction, the time when the fraud was discovered, and the course of conduct subsequently followed by a person who discovers he has been defrauded.

41/ We do not believe that the defendants' characterization of this suit as an attempt by disappointed investors to recover their losses "at the expense of their fellow losers," i.e., the other limited partners, is apt. See Brief for Appellees Fleschner, Becker and FBA at p. 32. We do not perceive that any cause of action has been made in the complaint which would allow plaintiffs, if successful, to recover against the partnership's assets held in trust for the limited partners, against whom no claim has been asserted.

The allegations of the complaint herein are that the plaintiffs entered into a continuing relationship with the defendants in which all parties contemplated that a series of transactions in securities would be effected by the general partners on behalf of the limited partners, including the plaintiffs. The plaintiffs allege that they authorized the defendants to invest in conservative, liquid securities, and that the defendants so agreed.[42/] Defendants adhered to a conservative investment strategy for a time, it is further alleged, and then departed from this course of action to invest more and more heavily in restricted, illiquid, and riskier securities. Taking the allegations of the complaint as established, it is only these riskier transactions that were affected by any violation of the antifraud provisions of the securities laws.

By limiting its inquiry to a computation of the plaintiffs' net profit or loss over the entire term of their participation in the limited partnership, however, the district court failed to distinguish between transactions that were affected by fraud, and those that were not. One possible result of this approach is that losses on transactions affected by the defendants' violations might have been offset by profits on other transactions. We submit that there is no reason why the district

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42/ While this allegation is somewhat contradicted by the broad wording of the partnership agreement, which authorizes virtually any sort of investment at the sole discretion of the general partners, it is supported, as the court below recognized, by the fact that the general partners consistently characterized their approach to investment opportunities as "low risk" or "conservative." See App. 293-294a. The question of whether the defendant general partners acted in violation of their agreement with the plaintiffs presents a factual question which was not addressed by the court below.

court should have offset "out-of-pocket" losses on transactions affected with fraud with profits on any transactions which resulted in gain.

The Commission is aware of no case which would allow damages resulting from transactions involving antifraud violations to be offset by profitable transactions. In Stevens v. Abbott, Proctor & Paine, 288 F.Supp. 836, 849 (E.D. Va., 1968), the court awarded damages to plaintiff resulting from excessive trading of her discretionary account by a broker-dealer, specifically declining to offset losses due to excessive commissions with the overall profit made on the trades made by the broker. The same type of computation was made in another "churning" case, Hecht v. Harris, Upham & Co., 430 F.2d 1202 (C.A. 9, 1970), without discussion of this issue. Although plaintiff in that case suffered a net loss, it is clear that some trades made on his behalf had resulted in profit for the plaintiff; nevertheless, the commissions charged on all trades were included in the damages.

In an action seeking recovery of "short-swing" profits under Section 16(b) of the Securities Exchange Act, this Court long ago held that in computing the amount of the recovery, losses incurred on short-term transactions should not be offset against profits. Smolowe v. Delendo Corp., 136 F.2d 231, 239 (C.A. 2), certiorari denied, 320 U.S. 751 (1943). An insider who engages in short-term trading must therefore accept his losses on some short-swing trades while disgorging his profits on any such trades that were profitable--

even if a net loss was realized on all the transactions. 43/ As the Court noted, there are indeed sound policy reasons why offsetting should not be allowed, and those considerations are equally applicable in a case involving antifraud violations.

A fiduciary having discretion with respect to management of the funds of another may engage in transactions which, over a period of time, result in considerable profit. If he knows that damages will be computed according to a rule which allows offsetting of profits, he will necessarily realize that he is in a position to engage in manipulative or deceptive or other fraudulent courses of conduct free from the deterrent effect of a private action for damages, since even substantial damage to the investors whose funds he manages will not be considered "out-of-pocket" losses. If the rule were that losses were offset by profits, could a fiduciary simply steal the net profits, leaving the original investment intact, and provide falsified statements to his clients, without liability for damages under the antifraud provisions of the federal securities laws? 44/ If so, only when the clients' losses began to approach the level of the previously accumulated profits would the fiduciary again feel the constraints of those laws. The congressional scheme embodied in the federal securities laws, however, is not one which, properly construed, allows fiduciaries any free "bites."

43/ Moreover, this Court held, purchases and sales are matched in the way that achieves the maximum amount the insider is required to repay to the corporation. 136 F.2d at 237.

44/ See Bird v. Ferry, 497 F.2d 112 (C.A. 5, 1974), in which a broker who acted as counsel to an investment club was held to have violated Rule 10b-5 by converting the investors' funds to his own use and concealing his actions by providing false financial statements to the club's members.

We submit that the defendants' motion for summary judgment should have been denied by the court below, as the record is insufficient at this point to allow the court to discover whether any "actual" losses have been suffered by the plaintiffs. We further suggest that the proper method for the district court to proceed in this action is by:

(1) determining if there was any violation of the antifraud provisions of the federal securities laws, i.e. whether the defendants effected transactions in violation of their agreement with plaintiffs;

(2) determining which transactions were affected by fraud;

(3) determining whether plaintiffs suffered any "out-of-pocket" losses with respect to those transactions affected by an antifraud violation.

If there were such losses on some transactions, they should not be offset by profits defendants may have made on any other transactions, even other transactions affected by fraud. While such a rule may have an effect of allowing plaintiffs a "windfall" of receiving the benefits of transactions that the defendants should never have entered into, that consideration is secondary to the need for a deterrent which will prevent investment advisers and other fiduciaries from taking impermissible risks with the funds of others. The rule applied by the district court may well have the effect of encouraging such speculation,[45/] since the fiduciary will know that one highly profitable

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45/ As noted in Smolowe v. Delendo Corp., supra, a rule which allowed offsetting of short-term profits against losses would tend "to stimulate more active [short-term] trading by reducing the chance of penalty." 136 F.2d at 239.

investment may completely erase his liability for many unprofitable transactions which were affected by antifraud violations.

CONCLUSION

For the foregoing reasons, the order of the district court dismissing the complaint should be reversed.

Respectfully submitted,

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