SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISORS ACT OF 1940, Release No. 40
SECURITIES EXCHANGE ACT OF 1934, Release No. 3653
SECURITIES ACT OF 1933, Release No. 3043

February 5, 1945

TEXT:

The Securities and Exchange Commission today made public an opinion by James A. Treanor, Jr., Director of its Trading and Exchange Division, to the effect that it is unlawful for an investment adviser (whether or not registered under the Investment Advisers Act) to effect a transaction with or for a client, either as a principal or as a broker for another person, unless he obtains the client's consent on the basis of full disclosure of any adverse interest he may have. This disclosure, the opinion states, must include a statement of the capacity in which the investment adviser proposes to act, the cost of the security to the investment adviser where he proposes to sell, and the best price at which the transaction could be effected by or for the client elsewhere if such price is more advantageous to the client than the actual purchase or sale price. The opinion states further that (except where no advice is rendered as to the particular transaction) the Investment Advisers Act requires in the case of a registered investment adviser that the disclosure of capacity be given in writing and the client's consent obtained before the completion of each transaction of the types in question.

The text of the opinion follows:

"The question has been presented whether it is permissible for an investment adviser to sell a security to or buy a security from a client. You ask also what disclosure is necessary if such a transaction is permissible.

"Section 206 of the Investment Advisers Act of 1940 provides:

"'It shall be unlawful for any investment adviser registered under section 203, 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;
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> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
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> (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 (3) 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.'

"An investment adviser is a fiduciary. As such he is required by the common law to serve the interests of his client with undivided loyalty. In my opinion a breach of this duty may constitute a fraud within the meaning of clauses (1) and (2) of Section 206 of the Investment Advisers Act (as well as the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934).

"It follows that an investment adviser may not effect a transaction as principal with a client unless he obtains the client's consent to the transaction after fully disclosing any adverse interest he may have, together with any other information in his possession which the client should possess in order to determine whether he should enter into the transaction. The disclosure should include, as a minimum,

(a) the capacity in which the investment adviser proposes to act, (b) the cost to the adviser of any security which he proposes to sell to his client (or, if he proposes to buy a security from his client and knows or is reasonably certain of the price at which it is to be resold, a statement of that price), and (c) the best price at which the transaction could be effected by or for the client elsewhere if such price is more advantageous to the client than the actual purchase or sale price. Moreover, any disclosure of the cost to the investment adviser (or the price he expects to receive on resale) should be so phrased that its full import is obvious to the client. The disclosure should include a statement of the total amount of the cost or resale price (or the total profit) in dollars and cents; it would not suffice, in my opinion, merely to express a formula by which those amounts may be computed, or to limit the disclosure to a percentage figure or to a maximum number of points or dollars per share or bond.

"What has been said thus far is not limited to investment advisers who are registered under the Investment Advisers Act. Although Section 206 of that Act applies only to registered investment advisers, the over-all effect of the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 is to cover any transaction in a security by any person where use is made of the mails or of some means or instrumentality of interstate commerce. Consequently, investment advisers who are exempted from registration by one of the clauses of Section 203 (b) of the Investment Advisers Act are nevertheless subject to the anti-fraud provisions of the 1933 and 1934 Acts when, notwithstanding their fiduciary status, they seek to deal with clients on a principal basis.

"It is not essential that the disclosure of adverse interest be in writing so far as clauses (1) and (2) of Section 206 of the Investment Advisers Act, as well as the antf-fraud provisions of the 1933 and 1934 Acts, are concerned. However, aside from the general requirement of full disclosure and consent imposed by these provisions, clause (3) of Section 206 of the Investment Advisers Act, which applies only to registered investment advisers, requires specifically that the disclosure of the capacity in which the investment adviser is acting be given in writing and the client's consent obtained before the completion of the transaction. In my opinion the requirements of written disclosure and of consent contained in this clause must be satisfied before the completion of each separate transaction. A blanket disclosure and consent in a general agreement between investment adviser and client would not suffice.

"It will be noted that the specific provisions of clause (3) of Section 206 do 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.' n1 Whether an investment adviser is subject to the duties of a fiduciary under clauses (1) and (2) (and under the anti-fraud provisions of the 1933 and 1934 Acts) in respect of such a transaction depends on all the facts (including the type of general investment advice rendered) in each case.

"Everything which has been said thus far with respect to a transaction in which an investment adviser buys or sells for his own account as principal applies equally to a transaction for the account of a client in which the investment adviser acts as a broker for some other person. In such a transaction, of course, it is the investment adviser's total commission which must be disclosed in dollars and cents.

"Finally, it must be borne in mind that this opinion is limited to the requirements of federal law. I can express no opinion as to the applicable state law. It is clear, however, that investment advisers, in addition to complying with the federal law, are subject to whatever restrictions or requirements the common law or statutes of the particular state impose with respect to dealings between persons in a fiduciary relationship."

Footnote

n1 In any event, of course, Section 15 (c) (1) of the Securities Exchange Act of 1934 and the Commission's Rule X-1501-4 thereunder require every broker or dealer to give his customer written notification of his capacity "at or before" the completion of each transaction.