(Investment Advisers Release No. 214)

ADMINISTRATIVE PROCEEDING
FILE NO. 3-469

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
December 22, 1967

In the Matter of ROMAN S. GORSKI P. O. Box 222 Mars Hill, North Carolina (801-2400) Investment Advisers Act of 1940 - Section 203(d)	FINDINGS, OPINION AND ORDER REVOKING INVESTMENT ADVISER REGISTRATION

INVESTMENT ADVISER PROCEEDINGS

Grounds for Revocation

Improper and Fraudulent Compensation Arrangements

Failure to Restrict Assignability of Advisory Contracts

False and Misleading Statements Concerning Clients' Accounts

Failure to Amend Application for Registration

Failure to Produce Records for Examination

Where registered investment adviser entered into investment advisory contracts providing for compensation to him on basis of profits on transactions and amounts paid customer on sales of option contracts, without reference to losses or liabilities, and made false and misleading representations to clients concerning their accounts, contracts failed to prohibit assignment without consent of clients, and adviser failed promptly to amend application for registration to disclose compensation arrangements and discretionary authority over clients' accounts and to produce investment advisory contract for examination, held, in public interest to revoke investment adviser registration.

APPEARANCES:

John T. McLoughlin, of the New York Regional Office of the Commission, for the Division of Trading and Markets.

Lawrence C. Moore, of Moore & Gunn, for Roman S. Gorski.

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Following hearings in these proceedings pursuant to Section 203(d) of the Investment Advisers Act of 1940 ("Act"), the hearing examiner filed an initial decision in which he found that Roman S. Gorski ("registrant"), a registered investment adviser, had willfully violated

various provisions of the Act and concluded that registrant's registration should be suspended for six months. Our Division of Trading and Markets ("Division") filed a petition for review respecting the adequacy of this sanction. We granted review and the Division and registrant filed briefs.

1. We agree with the findings of the examiner that registrant willfully violated the anti-fraud provisions of Sections 206(1) and 206(2) as well as the prohibitions of Sections 205(1) and (2) of the Act.

In March 1963 registrant entered into an investment advisory contract with Mr. T., who was then over 90 years old, which authorized registrant to act as Mr. T.'s agent and to purchase and sell securities, puts, calls and straddles 1/ in Mr. T.'s name. The contract provided that registrant would receive as his compensation 25% of net profits, payable upon completion of each securities transaction, and 25% of the proceeds of sales of puts, calls and straddles, payable upon notification that the funds had been credited to Mr. T.'s account. In May 1963 registrant entered into a joint agreement with Mr. T. and Miss I., Mr. T.'s sister-in-law who was about 75 years old, which was identical to the March agreement. Registrant opened accounts with a brokerage firm for Mr. T. and then a joint account for Mr. T. and Miss I., and was given full authorization to trade securities, as well as to perform contracts and exercise rights relating thereto, and to withdraw funds and securities from the account.

Mr. T. and Miss I. deposited a total of about $14,000 in the accounts. During the period until registrant's resignation as investment adviser for the accounts in October 1964, registrant effected 39 sales of stocks for the accounts and 9 sales of straddles. Twenty-one of the stock sales were at a profit, in the total amount of $3,190, and 17 were at a loss, in the total amount of $4,495, and the straddles were sold for $4,600. Registrant's fees on stock sales (the 21 profitable ones and one sale at a loss on which a fee was erroneously charged) amounted to $891 and he received $1,150 as his fee on the straddles. Thus registrant's total fees of $2,041 were over 60% of the $3,295 net increment, before deduction of those fees, that the clients had realized as of the October 1964 date. In addition, the accounts realized losses of at least $10,514 upon the sale subsequent to registrant's resignation of stocks which were the subject of some of the straddles sold by the accounts at his direction prior to that time. 2/

Section 205(1) of the Act prohibits advisory contracts which provide for compensation to the adviser on the basis of a share of capital gains or appreciation of the funds involved. This prohibition is reflective of the Congress' awareness of "the delicate fiduciary nature of an investment advisory relationship" and its intent to strike at "all conflicts of interest which might incline an investment adviser - consciously or unconsciously - to render advice which was not disinterested." 3/

1/ A straddle is a combination of a put and a call giving the holder the right to buy from or sell to the seller of the straddle a specified number of shares at a fixed price for a stated period of time.

2/ Registrant did not at the time of or subsequent to his resignation alert his clients to the potential liabilities on the straddles in face of changes in the market price of the securities covered by the straddles or take steps to limit such liabilities.

3/ S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-192 (1963); Arleen W. Hughes, 27 S.E.C. 629 (1948), aff'd 174 F.2d 969 (C.A.D.C., 1949).

Under an arrangement for compensation based on and payable upon the realization of profits, such as that which registrant entered into and applied in the present case, the adviser is likely to be in a position of conflict with his client in that he may be inclined to take undue risks with the client's funds, since he participates in gains and has no chance of loss. He would also be tempted to time transactions on the basis of considerations relating to his compensation rather than the best interests of the client since his fee would be received only in the event of realized gains. 4/ That the clients' interests were actually subordinated in this manner in the present case is strongly suggested by the results of registrant's management of the accounts described above.

We find that registrant's agreement with Mr. T. and Miss I. which provided for advisory fees of 25 percent of the profits derived from securities transactions violated Section 205(1) of the Act. 5/ In addition, the agreement for registrant to receive 25 percent of the proceeds from sales of puts, calls or straddles regardless of whether any such options were ultimately exercised or resulted in gains or losses to registrant's clients also violated Section 205(1). The premium received upon sale of a put, call or straddle constitutes a "capital gain" within the meaning of that Section since it results from the disposition of rights respecting the security involved. Registrant asserts that the compensation agreements were adopted at the suggestion of Mr. T. We cannot believe, however, in view of the record before us, that Mr. T. or Miss I. understood the impact of these agreements, particularly in light of their advanced ages and lack of sophistication. In any event, registrant, a fiduciary, should have known that such agreements violated the Act.

We also find that registrant's charging 25 percent of the proceeds from the sales of straddles, despite the substantial risk that the seller would ultimately suffer a loss from such transactions, constituted, under the circumstances herein discussed, a breach of registrant's fiduciary duty to deal fairly with his clients and a fraudulent course of conduct in violation of Section 206 of the Act. It is obvious from the record, including registrant's own testimony, that Mr. T. and Miss I. did not understand the risks in such agreements. Even assuming that registrant's clients, under the circumstances, were capable of understanding such risks, registrant never adequately explained the risks to them or the steps that could be taken to lessen the risks. Registrant's violation is compounded by the fact that he had complete discretionary authority over transactions in his clients' accounts, and, therefore, could risk his clients' capital for personal profit by selling a straddle without informing his clients.

4/ See Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies (Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services) (1939) p. 30: "Arrangements for contingent compensation to investment counselors, such as percentage of profits, [were] strongly condemned [by industry representatives] as inimical to the interest of the client, for ..., aside from the 'heads I win, tails you lose' aspect of such arrangements, such a basis of compensation 'encouraged the advisor to recommend a degree of risk that the investor himself would not knowingly undertake, inasmuch as the advisor has everything to gain if he is successful and nothing to lose if he is wrong' and 'may have been a strong temptation to take unusual risks, and to speculate or overtrade.'"

5/ The advisory contracts with Mr. T. and Miss I. were also violative of Section 205(2) of the Act in that they failed to provide, as required by that Section, that they could not be assigned without the clients' consent.

We reject registrant's contention that no finding of willful violations is warranted because any violations were inadvertent and not intentional. A finding of willfulness does not require a specific intention to violate the law or an awareness that the law is being violated; it is enough that the person charged with the duty knows that he is doing the act which constitutes the violation. 6/

Registrant also willfully violated the anti-fraud provisions of Section 206 of the Act in that he made false and misleading statements to Mr. T. and Miss I. regarding the profitability of their accounts. Two bills sent by registrant to Mr. T. in February and April 1964 showed profits on sales effected of $352 and $157 when the actual gain on the first was only $21 and the second produced a loss of $970. In addition, in March 1965, after several requests for an accounting, registrant sent Miss I. statements purporting to show gains or losses realized by the accounts during 1963 and 1964, respectively. The statement for 1963, which actually covered only April-July of that year, stated that total net profits were $4,719 when the actual profit for the year was $1,612. Moreover, that statement included in net profits $2,325 received on the sale of 5 straddles that were still outstanding in August 1963. It was false and misleading to characterize the $2,325 as a profit at that time in view of the potential liabilities and losses attaching to the straddles. In fact the accounts later in 1963 and in 1964 suffered a loss of $2,275 upon the completion of those straddle transactions. The statement for 1964, on the other hand, incorrectly stated that the accounts had sustained a net loss of $749 when a profit of $701 had been realized. At the very least, these misstatements demonstrate a gross indifference by registrant to his obligation to account accurately to his clients.

2. Registrant also willfully violated Section 204 of the Act and Rule 204-1(b) (17 CFR 275.204-1(b)) thereunder by failing to file promptly amendments to his application for registration to correct information which had become inaccurate.

A supplement to his application for registration filed by registrant in September 1961 stated that his compensation was computed on a percentage basis related to the size of clients' accounts, that he did not have discretionary authority over securities transactions of clients and that he did not have custody or authority to obtain custody of clients' securities or funds. By virtue of the agreements discussed above, and the facts that registrant had authority to withdraw funds that had been deposited in a savings account by Mr. T. to cover compensation due to registrant and under an authorization executed in November 1963 had discretion to trade securities for another client, these statements became inaccurate. No correcting amendment was filed until March 1966, two months after the institution of these proceedings.

Moreover, registrant violated Section 204 of the Act by failing to produce for inspection an agreement with a client. During the course of a routine investment adviser inspection in June 1965 registrant, despite an appropriate request, failed to produce a current investment advisory contract.

3. We agree with the Division that registrant's registration as an investment adviser should be revoked. The violations committed by him demonstrate a gross disregard of his obligations as an investment

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6/ See Hughes v. S.E.C., 174 F.2d 969 (C.A.D.C., 1949); Tager v. S.E.C., 344 F.2d 5, 8 (C.A. 2, 1965); Justin Federman Stone, 41 S.E.C. 717, 722 (1963).

adviser. Registrant states that he is a professor of economics and finance and the author of numerous articles in those fields, and that he has not been the subject of any prior disciplinary proceedings. In our view, however, these factors cannot overcome the very serious nature of the violations found. Indeed, in view of his educational background and indicated sophistication registrant should have been particularly aware of the basic unfairness and excessiveness, let alone the illegality, of the arrangements for fees of 25% of the profits on stock sales and of the proceeds of straddles, which carried with them a substantial risk of subsequent loss, and of the necessity for timely and accurate disclosure to clients of all pertinent facts regarding their accounts and for full compliance with all statutory requirements and standards applicable to investment advisers. 7/

Accordingly, IT IS ORDERED that the registration as an investment adviser of Roman S. Gorski be, and it hereby is, revoked.

By the Commission (Chairman COHEN and Commissioners OWENS, BUDGE, WHEAT and SMITH).

Orval L. DuBois
Secretary

7/ See Anne Caseley Robin, 41 S.E.C. 634, 638 (1963).