

**Court of Appeals  
of the  
State of New York**

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ASSURED GUARANTY (UK) LTD.,

*Plaintiff-Appellant-Respondent,*

-against-

J.P. MORGAN INVESTMENT MANAGEMENT INC.,

*Defendant-Respondent-Appellant.*

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**BRIEF FOR AMICI CURIAE THE SECURITIES INDUSTRY  
AND FINANCIAL MARKETS ASSOCIATION; THE CLEARING  
HOUSE ASSOCIATION L.L.C.; THE AMERICAN BANKERS  
ASSOCIATION; AND THE NEW YORK BANKERS  
ASSOCIATION IN SUPPORT OF DEFENDANT-RESPONDENT-  
APPELLANT**

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## **INTEREST OF AMICI CURIAE**

The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks, and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation, and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association.

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S.

The American Bankers Association (ABA) is the principal national trade association of the banking industry in the United States. It represents banks and holding companies of all sizes in each of the fifty states and the District of Columbia, including community, regional and money center banks. The ABA also represents savings associations, trust companies and savings banks. ABA members hold an overwhelming majority—approximately 95 percent—of the domestic assets of the U.S. banking industry. The ABA frequently appears in litigation, either as a party or amicus curiae, in order to protect and promote the interests of the banking industry and its members.

The New York Bankers Association is comprised of the community, regional, and money center commercial banks and thrift institutions doing business in New York State. In aggregate, members of the Association employ approximately 200,000 New Yorkers and hold more than \$9 trillion in assets.

Each of the amici (and its members) are concerned with the efficient functioning of the capital markets. Amici understand that financial-service providers—including the investment advisory industry—play a crucial role in the capital markets by bridging the gap between firms seeking capital and individuals and institutions seeking to make investments. Amici recognize that a robust and active industry of investment advisers will help provide millions of Americans the opportunity to build their capital. Amici are concerned that the decision of the

First Department to allow non-fraud tort claims against investment advisers—in effect, claims that such advisers failed to deliver sufficient returns to their clients—will impose substantial costs and unnecessary regulatory burdens on advisers, which in turn will result in higher costs, reduced returns, and narrower investment choices for investors. Amici believe that the First Department’s decision is impractical, harmful, and should be reversed.

### **INTRODUCTION AND SUMMARY OF ARGUMENT**

A. The question presented is whether the Martin Act preempts private non-fraud common-law tort claims regarding the provision of investment advice and other securities services. As a matter of statutory interpretation, J.P. Morgan’s briefs persuasively demonstrate that the answer is yes. In particular, amici agree with J.P. Morgan that, until the First Department’s ruling in this case, state and federal courts applying New York law had held with virtual unanimity that cases such as this one could not go forward, that the Legislature had acquiesced in those rulings, and that the law on this point was until recently stable and settled. *See* J.P. Morgan Br. 14-19, 36-42. Plaintiff, therefore, is seeking a significant change in the law, one that could have far-reaching and negative consequences for investors and for the securities markets, which are heavily concentrated in this State.

This Court should decline Plaintiff’s invitation to depart from decades of judicial decisions. Some of Plaintiff’s amici urge affirmance on policy grounds,

arguing that investors will be harmed unless private, non-scienter-based claims can be brought against investment professionals. But there are weighty considerations that counsel in favor of leaving the law where it was until the First Department's ruling—*i.e.*, finding preemption of claims like those here. Those considerations, which are elaborated below, demonstrate that the reach of Martin Act preemption is properly a question for the Legislature, which has the institutional capability to evaluate and, to the extent necessary, reconcile the competing policy interests.

The policy considerations discussed herein also offer a ready explanation for the Legislature's prolonged acquiescence in federal and state decisions finding non-scienter-based claims to be preempted—decisions that have created settled expectations in the investment community. If those expectations are to be disturbed now on the basis of the contrary considerations offered by Plaintiff's amici (or for any other reason), it should be done by the Legislature rather than the courts.

B. The legal rule espoused by Defendant J.P. Morgan—that the Martin Act preempts private non-fraud common-law tort claims in the securities context—reflects sensible policy. Investment advisers who select and manage securities for their clients in good faith (that is, in the absence of fraud) should not be subject to potentially crippling liability merely because, in hindsight, it turned out that they failed to foresee a risk that had a detrimental effect on a particular investment at a

particular point in time. The contrary rule embraced by the First Department could have substantial and negative consequences for the entire investment advisory industry, including asset managers, broker-dealers, investment advisers, and financial planners, as well as for ordinary investors.<sup>1</sup>

The significant uncertainty that is inherent in the selection of securities for investment portfolios means that it would be difficult if not impossible to establish a workable standard of care in non-fraud suits against investment advisers. Such a regime requires articulation, *ex ante*, of the range of “reasonable” conduct for which there will be no liability (and the scope of unreasonable conduct that may result in liability). But the notion of a “reasonable” investment strategy is highly elusive. Investors vary widely in their appetite for risk, and in their investment time horizon—some investors desire safe returns year in and year out, whereas others are willing to tolerate large swings if they are compensated for the additional risk over a longer investment horizon. Moreover, while the causes of an unprofitable investment can sometimes be unraveled with 20/20 hindsight, negligence liability must be determined based on information that is reasonably foreseeable at the time the investment was made. Markets, however, are fraught

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<sup>1</sup> Amici’s arguments here focus on claims against investment advisers because that is the specific context of this case. Many of the arguments presented, however, apply equally to other claims regarding the provision of securities services (for example, against other financial-services companies) that might be permitted if this Court were to affirm the First Department’s decision.

with uncertainty and frequently fluctuate as a result of unforeseen and unforeseeable risks. Indeed, the recent financial crisis—which caused the losses for the mortgage-backed securities at issue here—is a prime example of an unforeseen market movement. In light of the complex nature of the securities markets and given the multiple causes that often drive an asset’s price, it is impractical for finders of fact to grade an investment adviser’s judgment in hindsight.

C. The costs of imposing non-fraud-based liability on investment advisers will be substantial, and as a result, investors will pay higher fees and hence receive a lower rate of return. It is well accepted that a liability regime that fails to provide clear guidelines for conduct results in overdeterrence: individuals take precautionary measures beyond what is prudent to decrease their risk of liability. Here, precautionary measures are costly, and those costs ultimately will be borne by the investors that the proposed liability regime is ostensibly intended to protect. Advisers may try to mitigate litigation risk by purchasing additional insurance for liability, or adding administrative layers, such as requiring greater documentation of investment decisions or implementing heightened review and supervision of investments. While these burdensome and costly measures may not improve the advice that clients receive, they will add to the fees that clients are charged, and erode investment returns for investors.

D. Finally, the Court should take no comfort that the claims in this case are brought under the headings of gross negligence and breach of fiduciary duty rather than simple negligence. However Plaintiff styles its case, it is attempting to establish and impose an objective standard of reasonableness for the selection of investments, which is ill-considered. Further, gross negligence claims against investment advisers would be just as impractical and costly as claims for ordinary negligence. This Court observed long ago that the distinction between gross and ordinary negligence is “shadowy and unsatisfactory.” *Dalton v. Hamilton Hotel Operating Co.*, 242 N.Y. 481, 487 (1926). Moreover, gross negligence claims—like ordinary negligence claims—are unlikely to be dismissed as a matter of law and will frequently be heard by juries. *See Food Pageant, Inc. v. Consolidated Edison Co.*, 54 N.Y.2d 167, 172-173 (1981). And, to the extent Plaintiff’s breach of fiduciary duty claim rests on such concepts as an industry standard of care, it is no different from its gross negligence claim. *Compare* Am. Compl. ¶¶ 98-113 (breach of fiduciary duty) *with id.* ¶¶ 114-119 (gross negligence). Accordingly, there is both a substantial likelihood that investment advisers will have to pay the high price to settle or thoroughly litigate such suits—even frivolous ones—and the “unsatisfactory” risk that advisers may be found liable for gross negligence because the trier of fact could not discern the “shadowy” line between negligence and gross negligence.

As noted, over the past several decades most federal and state courts to consider the question have concluded that the Martin Act preempts non-fraud claims, and Plaintiff has presented no compelling reason to upset the reasonable expectations that such claims are preempted in this State. If the Legislature wishes to authorize such suits, it can do so clearly at any time. But it would be unwise and impractical for courts to take that step on their own.

### **ARGUMENT**

#### **A. A Ruling That Private Non-Scienter-Based Claims Can Go Forward Would Constitute A Significant Change In The Law, With Potentially Far-Reaching Consequences Best Considered By The Legislature**

The question in this case is whether the Martin Act preempts non-fraud common-law tort claims by private actors in the securities context. Resolution of that question is of great importance because the securities industry is centered in New York, making it the natural forum for most claims like those at issue here. In addition, amici's experience is that parties very often choose to have their contractual relationships governed by New York law, in part because of the stability of this State's law. Thus, resolution of the question presented in this case is likely to have far-reaching consequences for investors and for the securities markets.

J.P. Morgan Investment Management has cogently explained in its briefs why, as a matter of statutory interpretation, the answer to the question presented is

yes. To avoid burdening the Court, J.P. Morgan’s arguments will not simply be reiterated here, but amici fully endorse and join in them.

Amici do emphasize, however, that they agree in particular with J.P. Morgan that the ruling sought by Plaintiff would be a significant departure from the stable and settled law of New York as it had been applied by state and federal courts until the First Department’s ruling in this case. *See* J.P. Morgan Br. 14-19, 36-42.

Although this Court had not directly addressed the question, those other courts—with only a few exceptions—consistently held that the Martin Act preempts private non-scienter-based claims like those brought in this case. Investment professionals and investors have arranged their affairs for decades in light of those settled rulings, and upsetting those expectations now could have sweeping effects.

In urging this Court to uphold the First Department’s decision, several amici have invoked policy rationales, principally that investors will be harmed unless non-scienter-based lawsuits may be brought. *See* Pub. Investors Arbitration Bar Ass’n Amicus Br. 4 (“[P]reemption would leave a large gap in investor protection.”); N.Y. AFL-CIO et al. Amicus Br. 21 (“[P]reemption would block meritorious lawsuits, ... prompting a further deterioration of public confidence in the securities market.”). As we explain below, those arguments are questionable at best, and there are powerful reasons to conclude that the liability regime Plaintiff and their amici seek would have negative consequences for investors, principally

because it would likely impose greater costs on, and lessen returns for, all investors without a corresponding increase in investor protection.

But even if the policy arguments are debatable, J.P. Morgan rightly observes that, until recently, the settled law has been that private non-scienter-based lawsuits could not go forward. It is Plaintiff, therefore, that is seeking a significant change in the law, and given the potential consequences of that change, it is Plaintiff that must establish both that this Court is the proper body to effectuate the change in the law, and that the consequences following from that change will be positive and justifiable. That showing has not been made.

The fact that there are, at a minimum, competing policy considerations to be addressed is important for two reasons. First, it underscores that whether or not non-fraud common-law claims like those asserted in this case should be allowed to proceed requires balancing a host of factors and considerations, many of them fact-intensive and empirical. Evaluating these factors and conducting that balancing is a task that should be carried out by the Legislature. The Legislature has the necessary institutional competence; it can hold hearings and otherwise engage in fact-finding, and as a politically accountable body it is appropriately responsive to the competing considerations and constituencies.

Second, and relatedly, these countervailing policy considerations fully explain why the Legislature has acquiesced in the significant body of state and

federal judicial decisions holding that the Martin Act preempts claims like those here. As J.P. Morgan explains, the Legislature has repeatedly amended the Martin Act in recent years without doing anything to correct that body of state and federal decisions, thereby making clear that it agrees with them. The policy considerations elaborated in the remainder of this brief provide ample basis for that legislative approval. To the extent investors or others seek to have the law changed now because of their own policy arguments (or for other reasons), they should bring those arguments to the Legislature and not to this Court.

**B. Investment Advice and Management Are Not Activities Readily Susceptible To Evaluation Under A Reasonableness Standard**

As has been long understood, “the business of the law of torts is to fix the dividing line between those cases in which a [person] is liable for harm which he has done, and those in which he is not.” Holmes, *The Common Law* 79 (1881). In the context of negligence claims, for example, courts must first determine what the objective standard of care—often referred to as “ordinary,” “reasonable,” or “prudent” care—is for the particular conduct under consideration. *See Mangam v. Brooklyn R.R. Co.*, 38 N.Y. 455, 457 (1868) (“Legal negligence is the omission of such care as persons of ordinary prudence exercise and deem adequate to the circumstances of the case.”).

The premise of such claims is that the activity in question is properly subject to an objective standard of care—usually stated in terms of reasonableness. *See*

*People v. Grogan*, 260 N.Y. 138, 148-149 (1932) (negligence is “the failure to exercise the care of the reasonably prudent man”). Moreover, to yield the socially optimal standard of behavior—neither overdetering socially valuable activity nor underdetering undesirable actions—the standard should be stated in clear and generally applicable terms. There are strong reasons to conclude, however, that the rendering of investment advice and the management of investments are less susceptible to an objective standard of care than are other services.

*First*, investing inherently involves judgment and discretion to manage risks and uncertainty. While investment professionals can render informed judgment about the likely prospects that they perceive for an investment strategy, the potential factors influencing the profitability of an investment are innumerable, and in many cases unforeseeable. The profitability of investments can be influenced by many factors—short-term or long-term market movements, changing climate patterns, political developments, even the outbreak of war—that cannot be evaluated under a standard of care. *Second*, the profit or loss on any one investment cannot be evaluated in isolation, for that investment will usually constitute only one piece of an investor’s broader portfolio. *Third*, the price of an investment depends on innumerable factors, including timing; an investment that declines in value today may rise tomorrow, and when an investor elects to realize a loss (or gain) in turn depends on many other factors, including individual risk

appetite, tax strategies, panic, or simply an unanticipated change in the investor's circumstances that makes his or her need for liquidity different than the originally intended investment horizon.

**1. Investments Are Inherently Risky, And Developments That Cause An Investment To Decline In Value Are Often Unforeseeable**

Under long-settled New York law, liability for failure to adhere to a standard of care requires that the harm have been reasonably foreseeable when the activity in question took place. "Whether a breach of duty has occurred, of course, depends upon whether the resulting injury was a reasonably foreseeable consequence of the defendant[']s conduct." *Danielenko v. Kinney Rent A Car, Inc.*, 57 N.Y.2d 198, 204 (1982). And as this Court has also recognized, a claim based on breach of duty of care cannot be pieced together in hindsight. "Whether hindsight reveals that greater precautions could have been taken to avoid the harm that eventuated is irrelevant if the injury could not reasonably have been foreseen at the moment the defendant engaged in the activity which later proves harmful." *Id.*

If liability for providing investment advice and investment management services were based on failure to meet an objective standard of care, the crucial question would be what market risks a reasonable adviser should have foreseen at the time he made an investment decision. Hardly any field of human endeavor, however, is as fraught with uncertainty as the selection of investments. Of course,

investment professionals exercise reasoned judgment and rely on their experience in recommending and choosing investments for their clients. At great expense, specialized and proprietary financial models are developed in the best interest of achieving the highest risk-return tradeoff for advisers' clients. But investments are inherently risky, and many investments that once seemed, after extensive due diligence and study, to be promising turn out to be bitterly disappointing. The causes for such underperformance are innumerable. Technological breakthroughs may not materialize; supplies of the necessary quality may not be available for a reasonable price; the anticipated price for a company's product may unexpectedly collapse; or key company personnel may turn out to lack the necessary skill or drive to attain profitability, or may leave the company for other opportunities.

Moreover, an asset's price is always affected by exogenous factors. Markets fluctuate for many reasons that may have nothing to do with the perceived fundamentals of a particular asset. "Markets, after all, are volatile and unpredictable." Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 Calif. L. Rev. 627, 660 (1996). Even investments that are traditionally perceived as relatively safe, such as U.S. blue-chip stocks or Treasury bonds, fluctuate in value because of many external factors, including interest rates, currency fluctuations, legislative developments, weather, and geopolitical events. The

performance of more illiquid or complex investments—for instance, high-yield debt, emerging market securities, or derivatives—may depend on an even more diverse array of factors.

While investment advisers can exercise reasoned judgment about the upside potential of an investment, markets often move based on unforeseen and unforeseeable developments. The mortgage-backed securities at issue in this case are a prime example. Defendant selected the investments for Plaintiff in 2005, well before the crash in the housing and securities markets and credit markets froze. The financial crisis that depressed the value of Plaintiff's securities was without precedent in recent American history, and experts are still debating its causes. Moreover, that crisis depressed nearly every asset class in the markets. Many investment professionals failed to anticipate that crash, and hardly any investor managed to avoid its consequences.

Since investment advisers cannot foresee all market risks, some investment decisions will be unsuccessful. "Predicting [the future value of a security] is a most hazardous occupation. It requires not only the knowledge and skill of an economist, but also the acumen of a psychologist." Malkiel, *A Random Walk Down Wall Street* 104 (1999 ed.). And occasionally, losses will be substantial (as they have been during the recent financial crisis). "As long as humans, not robots, make the markets, bubbles and crashes will be a reality." Lo & Hasanhozic,

*Evolution of Technical Analysis: Financial Prediction from Babylonian Tablets to Bloomberg Terminals* xi (2010). Although investment advisers seek to maximize returns for their clients, investors “must recognize the existence of a *speculative factor*” in entering the markets and must “be prepared financial and psychologically for adverse results that may be of short or long duration.” Graham, *The Intelligent Investor* 20 (2003 ed.).

## **2. The Performance of Any Security Cannot Be Isolated From Its Role In A Client’s Broader Investment Portfolio**

If non-fraud lawsuits regarding the selection of investment securities were approved, investors could well bring such claims against investment advisers when *any* of their investments fared poorly, even if others succeeded. But it is unreasonable to evaluate the performance of one security (or even one class of securities) in a vacuum. Most investment advisers today follow the “modern portfolio theory,” which recommends that an investment strategy rely on a diverse basket of securities, instead of a single asset class. The theory’s central premise is that “assets *[sh]ould not* be selected only on characteristics that [a]re unique to the security. Rather, an investor [must] consider how each security co-moved with all other securities.” Elton and Gruber, *Modern Portfolio Theory, 1950 to Date*, 21 J. Banking & Fin. 1743, 1744 (1997). In other words, an investment adviser will typically put not all of a client’s money in a single security. Instead, it selects assets that balance and hedge each other. An investor’s portfolio may include

dozens of securities. Since different asset classes (or even different types of securities within a single asset class) frequently move apart from each other, a diversified portfolio may result in some losses and some gains. It thus makes little sense to separate one losing investment from a portfolio and allow it to serve—in isolation—as the basis for a negligence action. Plaintiff has suggested no means, however, for preventing such selectivity.

### **3. The Profit Or Loss On An Investment Depends On A Multitude Of Factors**

The profit or loss on an investment turns on a host of factors, including timing and the degree of risk an investor is willing to accept. Markets, of course, can fluctuate significantly. A security that is down today may be up tomorrow, next week, next month, or next year. “[N]early all investments are open-ended: poor performance is seldom established conclusively, since a turnaround is always possible.” Langevoort, *Selling Hope, Selling Risk*, 84 Calif. L. Rev. at 660. Yet lawsuits against investment advisers will usually be brought when the market is at its ebb. Investment advice may often seem incorrect when the market is on the downswing, even if the investment decision was prudent when made. Moreover, an investor’s appetite for risk may change dramatically over time: an investor who thought he was willing to accept significant fluctuations over a long term when he bought a higher-risk investment may change his mind when the market is down, and he may need to liquidate an investment quickly, for reasons that may have

nothing to do with the fundamentals of the investment (a job loss, a health crisis, the need to pay unexpected bills). But it is extraordinarily difficult, if not impossible, for investment professionals to “reasonably” anticipate changes in their clients’ appetite for risk over time. And, despite centuries of experience of investing, there is no clear yardstick for triers of fact to conclude that it is “reasonable” to set an investor’s time horizon at Time X, even when there might be a possibility that an investment would be profitable in one year after Time X.

\* \* \*

While investment advisers seek to forecast and mitigate investment risks for their clients as much as possible, some market movements and risks are unforeseeable by even the best advisers. In such cases, clients may well be disappointed with their investments. But allowing investment advisers to be sued by disappointed individual investors for, in essence, failing to deliver a sufficient rate of return, rather than restricting legal action to cases of true misconduct, is an impractical and inappropriately punitive remedy. Absent clear authorization from the Legislature, this Court should not permit claims such as the ones here to proceed.

**C. Allowing Non-Fraud Claims Against Investment Advisers Will Lead To Increased Costs for Clients**

The direct consequence of permitting non-fraud claims against investment advisers would be higher costs of providing investment services to clients, which

in turn would translate into reduced returns for investors. While some individual claimants may benefit from damage awards, for most investors the tort regime that Plaintiff seeks will be a losing proposition in part because all investors pay for higher costs regardless of their individual appetite for litigation. This Court should tread carefully before imposing such a steep, and unnecessary, burden on both the investment advisers and countless investors of this State.

The purpose of a liability regime premised on a duty of care is to encourage socially optimal behavior. “A negligence standard establishes a legally required level of precautions, usually defined as ‘reasonable care.’ Defendants who violate this requirement are held liable for the costs of all resulting accidents, and defendants who satisfy the requirements are not held liable at all.” Calfee & Craswell, *Some Effects of Uncertainty on Compliance With Legal Standards*, 70 Va. L. Rev. 965, 975 (1984). But when the nature of the relevant field makes it difficult or impossible to craft a coherent standard of “reasonable” care, individuals will take an overabundance of precautionary measures to reduce their risk of liability. This overdeterrence effect “may result in the addition of unnecessary costs or the unavailability of useful goods or services.” Shuman, *The Psychology of Deterrence in Tort Law*, 42 U. Kan. L. Rev. 115, 167 (1993). For that reason, Judge Posner has observed that “[t]he courts’ inability to determine optimal

activity levels except in simple cases is potentially a serious shortcoming of a negligence system.” Posner, *Economic Analysis of Law* 178 (7th ed. 2007).

Exposing investment advisers to liability for failure to exercise due care—in effect, failure to choose investments reasonably—will almost certainly result in overdeterrence. As explained in Part B, a workable standard of care for investment advisers would be difficult to establish. Without clear principles to follow, rational decisionmakers will manage litigation risk by opting for unnecessary precautions. Indeed, since the risk of investment losses—especially for larger investors—can be substantial, investment advisers would be imprudent not to take such measures. See Posner, *Economic Analysis of Law* 167-169 (suggesting that the greater the expected harm, the greater the need for precautions).

In particular, investment advisers would likely take various costly administrative precautions in order to mitigate adverse litigation outcomes. For example, they would likely need to invest in (or increase the value of) a litigation insurance policy. “Such coverage provides legal defense in the event an advisor is sued and also pays damages up to a certain amount if an advisor loses a lawsuit or chooses to settle to avoid litigation.” Waddell, *Protect Yourself* (July 2007), <http://www.advisorone.com/2007/07/01/protect-yourself> (visited Oct. 6, 2011). Prudent advisers would acquire such insurance because the costs of defending against a negligence suit—even a frivolous one—will be enormous. A firm could

have to pay hundreds of thousands of dollars, and more in particularly complex cases, to defend these types of lawsuits. *See id.* (noting that “[s]ome defense costs can reach into the hundreds of thousands of dollars”). Advisers will be moved to document their due diligence well beyond the socially optimal level before selecting an investment for a client. Advisers might also choose to settle (even meritless) suits to avoid the enormous costs and reputational harm of proceeding to trial. *Cf.* Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 *Stan. L. Rev.* 497 (1991). Or they might seek to protect themselves by, among other steps, retaining excessive documentation of investment decisions or implementing needlessly heightened review and supervision of investments—none of which is likely to improve the quality of the advice they provide to investors. All of these various measures are costly, and those costs will ultimately be borne by clients in the form of higher fees and lower investment returns.<sup>2</sup> Given that each basis point of return is dear for any investor,

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<sup>2</sup> *See, e.g.,* U.S. SEC, *Mutual Fund Fees and Expenses*, <http://www.sec.gov/answers/mffees.htm> (visited Oct. 6, 2011) (“A fund with high costs must perform better than a low-cost fund to generate the same returns for you. Even small differences in fees can translate into large differences in returns over time.”); FINRA—*Mutual Funds*, <http://www.finra.org/Investors/SmartInvesting/ChoosingInvestments/MutualFunds/> (visited Oct. 6, 2011) (“All mutual funds charge fees. Because small percentage differences can add up to a big dollar difference in the returns on your mutual funds, it’s important to be aware of all the fees associated with any fund you invest in.”).

forcing these unnecessary costs on clients is imprudent.<sup>3</sup>

This shift in the investment-advice industry, and the accompanying changes to the adviser-investor relationship, would come as a rude awakening to advisers and clients alike. As J.P. Morgan has demonstrated, there has been longstanding agreement, albeit not unanimous, among state and federal applying New York law that investment advisers are not subject to private non-scienter-based actions. As a result, advisers and clients have both been able to benefit from lower fees and a more trusting relationship in the absence of the threat of litigation. There is no reason for this Court to shift the playing field now. Investment advisers who, in good faith, make investment choices for the clients should not have those choices second-guessed in hindsight. That will impede—not empower—the adviser-client relationship.

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<sup>3</sup> The threat of litigation could even lead advisers to scale back their menu of investment options. Complex or illiquid investments have the greatest tradeoff of risk and reward and are most likely to be the subjects of negligence actions. Such investments can lead to large gains, and also result in substantial losses. Such investments are also the most likely to carry unforeseeable risks. If investment advisers faced a raft of litigation from these kinds of investments, they might decide not to offer them. At a minimum, investment advisers would surely have a greater incentive to charge premiums to clients seeking riskier investment products. And if, as is likely, more money were driven into lower yield/lower risk products, their return would fall even further as their need to offer high return so as to attract capital fell. The result would be a greater gap between the cost of capital for risk-taking entrepreneurs (which are highly productive when they succeed) and low-risk businesses, which offer investors relatively little growth.

**D. Gross Negligence And Breach Of Fiduciary Duty Claims Against Investment Advisers Would Be As Problematic As Ordinary Negligence Claims**

Plaintiff's claims are styled in terms of gross negligence and breach of fiduciary duty. But that does not soften the potentially far-reaching and burdensome impacts of allowing non-fraud tort suits against investment advisers.

In particular, the difference between gross and ordinary negligence is thin. As this Court has acknowledged, although there is a legal distinction between the theories, it is "oftentimes shadowy and unsatisfactory." *Dalton*, 242 N.Y. at 487. And as other courts have long warned, it is "quite impracticable exactly to distinguish them." *The Steamboat New World v. King*, 57 U.S. (16 How.) 469, 474 (1853). New York's model jury instructions reflect the slender difference between negligence and gross negligence; the instructions state only that gross negligence is "more than the failure to exercise reasonable care" and is "a failure to use even slight care, or conduct that is so careless as to show complete disregard for the rights and safety of others." N.Y. Pattern Jury Instructions § 2:10A.

It is unrealistic to expect that lay jurors lacking financial expertise will find the distinction between gross and ordinary negligence helpful when parsing a complicated investment decision in retrospect. It is just as likely that juries will elide the "shadowy" difference and find gross negligence even when there was none. And the juror confusion need only be slight to have a substantial impact on

in investment advisory industry. “[A]s long as *some* juries cannot distinguish negligence from gross negligence,” even a nominally gross-negligence regime “will still deter ordinary negligence as long as some juries cannot distinguish negligence from gross negligence or recklessness.” Johnston, *Punitive Liability: A New Paradigm of Efficiency in Tort Law*, 87 Colum. L. Rev. 1385, 1399 n.35 (1987) (emphasis added). As a result, an unclear gross-negligence regime will create the same pressure for overdeterrence as a regime where liability is predicated on a simple failure to exercise due care.

Furthermore, although the standard of care for gross and ordinary negligence claims is different, both types of claims are unlikely to be resolved as a matter of law and will regularly go before a jury. As this Court has noted, a gross negligence claim “remains a matter for jury determination.” *Food Pageant*, 54 N.Y.2d at 173. Negligence claims—of whatever flavor—implicate a fact-intensive inquiry, and even frivolous lawsuits will usually survive a motion to dismiss or a motion for summary judgment. Indeed, negligence suits “can rarely be decided as a matter of law.” *Andre v. Pomeroy*, 35 N.Y.2d 361, 364 (1974). Accordingly, investment advisers will need to spend substantial sums to defend or settle—or thousands of dollars in precautionary costs to avoid—negligence suits. These costs, again, would inevitably be passed on in large part to the investors of this State, sharply diminishing their investment returns.

The same concerns are raised when the claims are restyled as claims for breach of fiduciary duty. Fiduciary duty claims come in many forms, but in this case Plaintiff has, to a significant degree, based its breach of fiduciary duty claim on negligence concepts such as a failure to adhere to an industry standard of care. *See* Am. Compl. ¶ 104 (“JPMIM breached its duty to use an industry standard of care” in choosing investments). Thus, to the extent Plaintiff is attempting to proceed on a non-scienter-based claim, the fact that it labels that claim as “breach of fiduciary duty” rather than “negligence” or “gross negligence” should not matter; all such claims are essentially claims that the investment professional failed to act reasonably in choosing investments, and should not go forward for the reasons explained.

## CONCLUSION

This Court should reverse the order entered in this case by the Appellate Division, First Department on November 23, 2010, insofar as that order held that Assured's claims for gross negligence and breach of fiduciary duty were not preempted by the Martin Act.

Respectfully submitted,



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Dated: October 7, 2011

## **EXHIBIT A**

The Securities Industry and Financial Markets Association and The Clearing House Association, L.L.C. each have no parents, subsidiaries, or affiliates.

The American Bankers Association (ABA) has no parent corporation. Its subsidiaries are Business Solutions and the American Bankers Insurance Association. Its affiliates are the Corporation for American Banking, the ABA Education Foundation, the ABA Housing Partners Foundation, the ABA Marketing Network, the ABA Securities Association, the American Institute of Banking, BAFT-IFSA, and The Institute of Certified Bankers.

The New York Bankers Association has no parent corporation. Its subsidiaries are the New York Bankers Service Corporation and Circuit Agency, Inc. Its affiliates are the Group Creditors Insurance Trust, the Group Employee Insurance Trust, and the New York Bankers Retirement System.

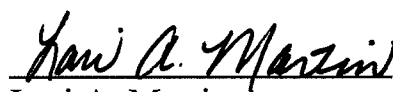
## CERTIFICATE OF SERVICE

I, Lori A. Martin, a member of the Bar of the State of New York, hereby certify under the penalty of perjury that on this 7th day of October, 2011, I caused two copies of the foregoing to be hand-delivered to each of the following individuals:

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