New York County Clerk's Index No. 601924/09

New York Supreme Court

APPELLATE DIVISION—FIRST DEPARTMENT

CMMF, LLC,

Plaintiff-Appellant-Cross-Respondent,

—against—

J.P. MORGAN INVESTMENT MANAGEMENT, INC. and TED C. UFFERFILGE,

Defendants-Respondents-Cross-Appellants.

BRIEF *AMICUS CURIAE* OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION IN SUPPORT OF DEFENDANTS-RESPONDENTS-CROSS-APPELLANTS

Lori A. Martin
WILMER CUTLER PICKERING HALE AND DORR LLP
399 Park Avenue
New York, New York 10022
(212) 230-8800

Paul R.Q. Wolfson
Daniel S. Volchok
WILMER CUTLER PICKERING HALE AND DORR LLP
1875 Pennsylvania Avenue N.W.
Washington, D.C. 20006
(202) 663-6000

Attorneys for the Securities Industry and Financial Markets Association

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INTRODUCTION AND INTEREST OF *AMICUS CURIAE*

Pursuant to 22 N.Y.C.R.R. § 500.23(a)(4), the Securities Industry and Financial Markets Associates ("SIFMA") respectfully submits this brief as *amicus curiae* in support of Defendants-Respondents-Cross-Appellants ("Defendants") in this case. SIFMA agrees with Defendants that the Supreme Court should have dismissed the claims of Plaintiff-Appellant-Cross-Respondent ("Plaintiff") for negligence, breach of fiduciary duty and negligent misrepresentation on the ground that they are preempted by the Martin Act, N.Y. Gen. Bus. Law §§ 352 *et seq.*[1/]

SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. With offices in New York and Washington, D.C., SIFMA is the U.S. regional member of the Global Financial Markets Association. 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. Fundamental to achieving this mission is earning, inspiring, and upholding the public's trust in the industry and the markets.

Whether private, common-law tort claims that are not based on fraud can proceed in the face of the Martin Act's sweeping delegation of authority to the Attorney General to investigate practices relating to the purchase and sale of

[1/] The Supreme Court rejected the Defendants' arguments that those three claims are preempted by the Martin Act, *see* Op. 9-10, but dismissed two of the claims, for negligence and breach of fiduciary duty, on grounds not addressed in this brief, *see id.* at 10-12.

securities is of substantial importance to SIFMA's members. As this case demonstrates, investments in securities sometimes do not yield the results that investors had hoped for, and SIFMA's members not infrequently find themselves defendants to lawsuits brought by disappointed investors. In the unusual circumstances where the defendant has engaged in fraud or has deviated from its contractual agreement with the investor about the investments to be selected, the courts of New York have allowed investors to pursue a remedy in court. But where, as in this case, there is no evidence that the defendant acted either fraudulently or in violation of its contractual understanding with the investor, the courts of this State have recognized that a cause of action by a disappointed investor—whether it be called negligence, negligent misrepresentation, or breach of fiduciary duty—comes perilously close to a claim that an investment manager should have done a better job in anticipating the swings of the market. Allowing an investor to pursue a claim for, in effect, negligent selection of investments could seriously chill investment-management activity.

The Martin Act gives the Attorney General exceptionally broad authority in policing the purchase and sale of securities in New York, and reaches well beyond the bounds of traditional, common-law fraud. The Attorney General may, for example, bring suit under the Martin Act on the basis that a statement accompanying the sale of securities is inaccurate, even if not intentionally so. But

precisely because the Martin Act is such a powerful tool, the courts of this State have recognized that it must be handled with care. The courts have therefore declined to allow private enforcement of the Martin Act, confining the statute's use to politically accountable officials who are accustomed to exercising informed discretion in determining whether the public interest warrants an enforcement action even in the absence of evidence of *scienter* or intentional mis-representations.

Plaintiff in this case seeks to bring exactly the kind of common-law claims that the courts have *not* allowed under the Martin Act—private non-fraud claims based on alleged inaccurate statements and missteps in the selection of investments Until the Supreme Court's decision in the instant case, most New York courts had concluded that such lawsuits could not be brought, because they are, in effect, private Martin Act claims, though presented under a common-law label. Indeed, this Court so held almost two decades ago in a materially indistinguishable case. This Court should reaffirm that ruling and conclude that a plaintiff may not evade the important limitations on enforcement of the Martin Act by pursuing a claim relating to the purchase of securities that is based neither in contract nor in actual fraud.

ARGUMENT

A. The Martin Act Preempts Plaintiff's Common-Law Tort Claims

The starting point for analysis of the Martin Act issue in this case is the recognition that Plaintiff's three common-law tort actions—purportedly based in negligence, negligent misrepresentation, and breach of fiduciary duty—go well beyond the bounds of traditional common-law fraud (indeed Plaintiff did not raise any traditional fraud claim in its complaint). Plaintiff's negligence claim is that Defendants did not exercise due care in choosing and monitoring investments for Plaintiff. *See* Compl. 32-33. Its breach of fiduciary duty claim is much the same, that Defendant mishandled its investments for Plaintiff. *See id.* at 33-34. And its negligent misrepresentation claim is that Defendants inaccurately reported to Plaintiff the credit quality of its investments. *See id.* at 34-35.

Although Plaintiff attempts to characterize these claims as unexceptional extensions of traditional common-law causes of action, that is far from the case. Hardly any field of human endeavor is as fraught with uncertainty—or as subject to second-guessing in hindsight—as that of the selection of investments in securities. While the law at both the state and federal levels has long prohibited outright fraud in the sale and purchase of securities, and in many cases has extended to investors a private right of action for redress of actual fraud, the prospect of subjecting investment managers and advisers to potentially crippling

damages liability for mistakes that they made in choosing securities (or advising clients on which securities to choose) raises very significant policy issues. Plaintiff would have the courts—and, more particularly, juries—sit in judgment over investment decisions that were made years earlier and that went wrong for complex and interrelated reasons.

That prospect explains why (as Defendants have shown) both New York and federal courts have concluded with striking uniformity that private common-law tort claims, not based in fraud but alleging negligence in the selection or advice of investments in securities, cannot proceed.[2/] This does not mean that investors in securities lack protection when *scienter* cannot be proven. To the contrary, the Court of Appeals has consistently ruled that the Martin Act, which prohibits all practices or transactions in the purchase or sale of securities that would "operate as

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[2/] Federal law is analogous to New York law in this respect. A private claim of actual fraud (including *scienter*) in connection with the purchase or sale of securities may be brought under Section 10(b) of the Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881, and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5. *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 380-382 (1983) (requiring *scienter* in a private Rule 10b-5 action). By contrast, the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6, imposes significantly broader duties on investment advisers than just the duty to avoid intentional deception, *see SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193-194 (1963)—but those broader duties are generally enforceable only by the SEC, and not in a private right of action for damages, *see Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 19-23 (1979).

a fraud,"[3/] does not require proof of *scienter*, but rather reaches "all acts, even though not originating in any actual evil design to perpetrate fraud or injury upon others, which do tend to deceive or mislead the purchasing public." *People v. Lexington Sixty-First Assocs.*, 38 N.Y.2d 588, 595 (1976); *see also State v. Rachmani Corp.*, 71 N.Y.2d 718, 725 n.6 (1988); *People v. Federated Radio Corp.*, 244 N.Y. 33, 38-39 (1926); *People v. Sala*, 258 A.D.2d 182, 193 (3d Dep't 1999), *aff'd*, 95 N.Y.2d 254 (2000).

But precisely because the Martin Act is so sweeping—reaching not only intentionally deceptive practices, but also all acts that "*tend to* deceive or mislead"—the Legislature has recognized that this powerful weapon must remain in steady hands. In *CPC International Inc. v. McKesson Corp.*, 70 N.Y.2d 268 (1987), the Court of Appeals stressed that "consistency of purpose" (of protecting purchasers of securities) required "consistency with this enforcement mechanism" (allowing the Attorney General to investigate and prosecute securities practices), such that private investors could not bring a claim under the Martin Act, *id.* at 268. The Court of Appeals so ruled, moreover, fully acknowledging the arguments that "a private cause of action would act as a further deterrent" and—what is especially

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[3/] *See* N.Y. Gen. Bus. Law § 352. The "operate as a fraud" language reaches beyond traditional, common-law fraud, and is identical to the language relied on by the U.S. Supreme Court in *Capital Gains Research Bureau* to conclude that the analogous provision of the Investment Advisers Act of 1940 prohibits more than traditional, intentional fraud. *See* 375 U.S. at 193.

pertinent here—that "[a] statutory cause of action in State court could *add a remedy* for defrauded investors in those cases *where none exists in common law fraud*, and where the Federal courts have denied relief under Federal law" (because of the *scienter* requirement under Rule 10b-5, *see* n.2, *supra*). *Id.* at 277-278 (emphasis added).

In other words, the *CPC* Court plainly understood that the issue before it was whether investors in securities who could not prove traditional, common-law fraud—because they could not prove intentional deception—would have a private cause of action in tort under New York law. To be sure, the plaintiff in *CPC* does not appear to have brought a separate common-law tort claim not based in fraud (it did bring fraud and express warranty claims). Nonetheless, the Court of Appeals notably did *not* suggest that the consequences of its ruling would be limited because the plaintiff might have such a common-law cause of action (for example, for negligent misrepresentation). Thus, the decision in *CPC* can only be understood as acknowledging that, unless the plaintiff in that case could prove traditional, common-law fraud (a claim which the Court elsewhere in its opinion allowed to proceed), it would have no damages claim in New York law against the defendant.[4/]

[4/] The Attorney General disputes this reading of *CPC* and notes that on the same day, the Court of Appeals decided *Green v. Santa Fe Industries, Inc.*, 70 N.Y.2d 244 (1987), in which it considered whether a plaintiff might bring a

Given this proper reading of *CPC*, it is unsurprising that the courts of this State—including this Court—have largely concluded that to allow disappointed investors to pursue a common-law tort action not based in actual fraud would effectively undermine the careful limits that the Legislature placed on enforcement of the Martin Act. As this Court explained, in the absence of actual fraud, "to sustain [such causes of action] would be, in effect, to recognize a private right of action under the Martin Act contrary to caselaw." *Horn v. 440 E. 57th Co.*, 151 A.D.2d 112, 119 (1st Dep't 1989); *see also Rego Park Gardens Owners, Inc. v. Rego Park Gardens Assocs.*, 191 A.D.2d 621, 622 (2d Dep't 1993) (similarly holding that "this cause of action [for negligent misrepresentation] sought, in essence, to pursue a private cause of action under the Martin Act" and should have been dismissed).

The Attorney General argues that parallel private lawsuits would supplement, not impair, his own enforcement of the Martin Act (*see* NYAG Br. 9), but that transient perspective is hardly dispositive. It is not uncommon for government agencies to wish that greater resources, even in the private sector, could be brought to bear on a particular regulatory problem. The question for this

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fiduciary duty claim in the context of a freeze-out merger. The Attorney General observes that the Court of Appeals nowhere suggested in *Green* that the fiduciary duty claim might be preempted by the Martin Act. *See* NYAG Br. 15-16. But the Attorney General fails to note that the fiduciary duty claim in that case arose under *Delaware* law—not New York law. *See Green*, 70 N.Y.2d at 250, 256.

Court, however, is whether the Legislature intended to centralize the enforcement power in a single, politically accountable agency, or whether the Legislature would have been content to allow a multiplicity of private lawsuits to be brought, perhaps in inappropriate or unwarranted cases, and potentially resulting in conflicting decisions extending liability and imposing draconian disclosure obligations. New York has a significant interest in ensuring that its laws are not construed in conflicting ways and that investment professionals are not subject to confusing standards with respect to their obligations The Court of Appeals decision in *CPC* provides guidance, for there too, it was argued that private enforcement would only supplement, and not impair, the Attorney General's enforcement of the Martin Act, and yet the Court concluded that the Legislature had not allowed private enforcement of the Act. *See* 70 N.Y.2d at 277-278.[5/] Following that guidance, courts have concluded that "allowing private litigants to press common law claims 'covered' by the Martin Act would upset the Attorney General's exclusive enforcement power in exactly the same way that it would upset the exclusive enforcement power to allow private claims pleaded under the Martin Act itself." *Kassover v. UBS AG*, 619 F. Supp. 2d 28, 37 (S.D.N.Y. 2008).[6/]

[5/] Similarly, in *Transamerica*, the SEC argued that private lawsuits would assist its own enforcement of the Investment Advisers Act, and yet the U.S. Supreme Court was unmoved. *See* 444 U.S. at 23.

[6/] The Attorney General mistakenly argues (NYAG Br. 13) that the distinction that has been drawn between non-fraud common-law claims (which are

B. Martin Act Preemption Is Not Limited To Cases Involving Co-op Shares

The Attorney General does not deny that most state and federal courts to address the issue have held that non-fraud common-law claims like those at issue here are preempted by the Martin Act. He seeks instead to cabin the leading decisions, contending (NYAG Br. 16) that they all "depend on" the real-estate context in which they arose—a context in which the Martin Act imposes specific affirmative disclosure obligations. *See* N.Y. Gen. Business Law § 352-e. More specifically, the Attorney General argues (NYAG Br. 17) that in each case, "the court found ... reliance" by the plaintiff(s) on those statutorily required disclosures, and therefore concluded that the underlying claims were thus impermissible private claims to enforce the Martin Act. Because the Martin Act

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preempted by the Martin Act) and *scienter*-based fraud claims (which are not) "is based on the mistaken premise that Martin Act claims and non-scienter-based common-law claims have exactly the same elements." That is not correct. Rather, the courts have concluded that common-law claims are preempted when they "essentially mimic" Martin Act claims, not when they have the same elements. *Nanopierce Techs., Inc. v. Southridge Capital Mgmt., LLC*, 2003 WL 22052894, at *4 (S.D.N.Y. Sept. 2, 2003) (citing *Horn*, 151 A.D.2d at 120). And that point is not undermined by the fact, noted by the Attorney General (NYAG Br. 13-14), that Martin Act claims omit certain elements of common-law claims like plaintiff's (for example, the special-trust-relationship element of negligent misrepresentation claims and the fiduciary-relationship element of breach of fiduciary duty claims). The omission of those elements from Martin Act claims simply allows the Attorney General, who will rarely if ever have a special or fiduciary relationship with a Martin Act defendant, to enforce that law. But that does not change the fact that Martin Act claims are essentially public-sector counterparts to these common-law claims. It is for that reason that the latter, unlike most common-law fraud claims, are preempted.

does not impose similar disclosure requirements outside the real estate context, the argument runs, the holdings of those cases—again, purportedly based on findings of reliance—are limited to that context. But as the Attorney General acknowledges (*id.* at 17 n.5), many of the decisions he cites in fact make *no* reference to such reliance, let alone a specific "finding" of it.

To fill this crucial gap in his argument, the Attorney General cites to the parties' appellate briefs in several of the cases. But that actually undercuts his argument, because the fact that reliance on Martin Act disclosures was not discussed in each opinion despite being properly presented to the court indicates, if anything, that each court declined to find such reliance or did not deem its preemption holding as depending on, and hence limited to, the real-estate context. *See, e.g.*, *Stolt-Nielsen S.A. v. Animalfeeds Int'l Corp.*, 559 U.S. ___, 2010 WL 1655826, at *7 (Apr. 27, 2010) (concluding that an arbitral panel did not accept one of the arguments presented to it because the panel's decision "said nothing about" the argument). Indeed, in this Court's decision in *Horn* in particular, there is not a hint that the Martin Act preemption issue turned on the fact that the sponsor had been required to make those disclosures in the offering statement.[7/] Similarly, while the Attorney General (NYAG Br. 17 n.5) points to the appellate

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[7/] By contrast, this Court did note that the specific context in which the parties' relationship arose, including the sponsor's superior information about the co-op's operations, was relevant to the fraud claim. *See Horn*, 151 A.D.2d at 119.

briefing in *Whitehall Tenants Corp. v. Estate of Olnick*, 213 A.D.2d 200 (1st Dep't 1995), to support his claim that this Court "found ... reliance" on the special real-estate disclosures required by the Martin Act in that case, this Court has made clear that it dismissed the plaintiff's claim in *Whitehall* because "there was *no* evidence of reliance by the allegedly defrauded shareholder," *Kramer v. W10Z/515 Real Estate Ltd. P'ship*, 44 A.D.3d 457, 459 (1st Dep't 2007) (emphasis added) (citing *Whitehall*, 213 A.D.2d at 200-201), *rev'd on other grounds sub nom. Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. P'ship*, 12 N.Y.3d 236 (2009).

In short, the Attorney General's contention (NYAG Br. 17) that "these real estate decisions shed no light on the questions presented here" is without merit—as, indeed, several cases have recognized in applying those decisions outside the real estate context. *See, e.g.*, *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 190 (2d Cir. 2001); *In re Bayou Hedge Fund Litig.*, 534 F. Supp. 2d 405, 421 (S.D.N.Y. 2007) ("Claims relating to 'investment advice' have been deemed 'activities within the Martin Act's purview.'" (quoting *Sedona Corp. v. Ladenburg Thalmann & Co.*, 2005 WL 1902780, at *21 (S.D.N.Y. Aug. 9, 2005))), *aff'd*, 573 F.3d 98 (2d Cir. 2009); *Jana Master Fund, Ltd. v. JPMorgan Chase & Co.*, 19 Misc.3d 1106(A), 859 N.Y.S.2d 903 (Table), at *6-*7 (Sup. Ct. Mar. 12, 2008). In fact, in perhaps the most recent decision addressing this issue, the court rejected precisely the argument the Attorney General advances here:

> In a somewhat inverted reading of the case, plaintiff asserts that *Kerusa* narrowed the scope of Martin Act preemption ... to claims based solely on nondisclosures or violations of statutory requirements created by the Martin Act itself. But ... [n]othing in the opinion suggests that the Court of Appeals, in expanding Martin Act preemption into the fraud realm, intended to diminish it with respect to other types of claims. A significant body of precedent has developed regarding preemption of, *inter alia*, negligence and breach of fiduciary duty claims, and this Court is unwilling to conclude that the New York Court of Appeals tacitly overturned it.

Stephenson v. Citco Group Ltd., ___ F. Supp. 2d ___, 2010 WL 1244007, at *12 (S.D.N.Y. Apr. 1, 2010); *see also id.* at *13 ("[T]he overwhelming weight of authority supports Martin Act preemption of negligence and breach of fiduciary duty claims arising in the securities context." (citing *Barron v. Igolnikov*, 2010 WL 882890 (S.D.N.Y. Mar. 10, 2010))). What all these courts have recognized is that the Appellate Division cases finding Martin Act preemption of claims like those at issue here should be read to hold exactly what the language in their opinions indicates, namely that "private plaintiffs will not be permitted through artful pleading to press *any* claim based on the sort of wrong given over to the Attorney-General under the Martin Act." *Whitehall*, 213 A.D.2d at 200 (emphasis added) (citing *Rego Park Gardens Owners*, 191 A.D.2d at 622).[8/] That approach is entirely sensible, because the rationale discussed in Part A for limiting the expansive liability imposed under the Martin Act by requiring actions to be

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[8/] In *Kramer* this Court approvingly reiterated this point from *Whitehall*. *See* 44 A.D.3d at 459.

brought by the Attorney-General applies with as much force outside the real-estate context as within it.

Finally, in seeking to counter the extensive case law undermining his position, the Attorney General (NYAG Br. 14-15) cites two Appellate Division cases that supposedly reached a different conclusion, *Scalp & Blade, Inc. v. Advest, Inc.*, 281 A.D.2d 882 (4th Dep't 2001), and *Rasmussen v. A.C.T. Environmental Services, Inc.*, 292 A.D.2d 710 (3d Dep't 2002). The *Scalp & Blade* decision, however, "offers virtually no ... reasoning at all; indeed, as has been observed, the decision does not even go so far as to explain why the Fourth Department is not longer persuaded by its prior decision in *Breakwaters* [*Townhomes Ass'n of Buffalo v. Breakwaters of Buffalo, Inc.*, 207 A.D.2d 963 (4th Dep't 1994)]." *Nanopierce Techs., Inc. v. Southridge Capital Mgmt., LLC*, 2003 WL 22052894, at *4 (S.D.N.Y. Sept. 2, 2003). And *Rasmussen* provides no support at all for the Attorney General. He asserts (NYAG Br. 15) that the *Rasmussen* court "reject[ed] without discussion the defendant's argument of Martin Act preemption." But the defendant *prevailed* in *Rasmussen*, *see* 292 A.D.2d at 711-712, and so there is no basis—given the lack of discussion by the court about the statute—to conclude that the court "reject[ed]" the defendant's Martin Act argument. The court simply ruled for the defendant on other grounds. The authority adopting the Attorney

General's position is thus even slimmer than he acknowledges, and certainly provides no compelling reason for this Court to abandon its precedent in *Horn*.

CONCLUSION

Plaintiff's claims for negligence, breach of fiduciary duty, and negligent misrepresentation should be dismissed.

Respectfully submitted,

Lori A. Martin
WILMER CUTLER PICKERING
HALE AND DORR LLP
399 Park Avenue
New York, N.Y. 10022
(212) 230-8800

Paul R.Q. Wolfson
Daniel S. Volchok
WILMER CUTLER PICKERING
HALE AND DORR LLP
1875 Pennsylvania Avenue N.W.
Washington, D.C. 20006
(202) 663-6000

Attorneys for Securities Industry and Financial Markets Association

Dated: April 30, 2010

PRINTING SPECIFICATIONS STATEMENT

This brief was prepared using Microsoft Word 2003. According to that program, the brief contains 3,688 words, excluding the cover page, tables of contents and authorities, signature block, this statement, and the certificate of service. The brief is written in Times New Roman 14-point font.