Securities Regulation Daily Wrap Up, TOP STORY—Mass. Sup. Jud. Ct.: Hedge fund adviser could not dodge liability for unsuitable sale, (Jun. 11, 2015)

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By John M. Jascob, J.D.

An investment adviser to a hedge fund incurred liability for soliciting an unsuitable investment in the fund in violation of the Massachusetts Uniform Securities Act (Act). The Massachusetts Supreme Judicial Court held that the adviser fell within the Act's definition of a "seller" of securities because he was motivated in part by the potential for personal financial gain from increased advisory fees. In addition, the investor's claims were not barred by the Act's statute of limitations because the adviser's breach of his fiduciary duty was equivalent to fraudulent concealment. Accordingly, the judgment against the defendants was affirmed (*Hays v. Ellrich*, June 10, 2015, Gants, R.).

Background. On the advice of her investment adviser, Molly A. Hays transferred approximately 75 percent of her retirement savings from registered mutual funds into a newly-created hedge fund managed by the adviser. When the hedge fund became insolvent in 2003, Hays lost nearly all of her investment. In 2006, Hays filed suit against the adviser, Morgan Financial Advisors, Inc. (MFA), and David J. Ellrich, MFA's sole owner and officer, alleging violations of the Act's anti-fraud provisions. After the trial judge found in Hays's favor, MFA and Ellrich appealed.

"Seller" liability. On appeal, Ellrich and MFA claimed that they could not be held liable under the statute's anti-fraud provisions because they were not "sellers" of securities. Although Ellrich did not deny soliciting Hays's purchase of the hedge fund interests, he contended that seller liability did not attach under the Act because he had no "financial interest" in Hays's purchase. Ellrich noted that he did not receive a commission on the transaction, nor did he receive any other compensation directly tied to the sale. He also pointed out that the management fee he earned as the hedge fund's adviser—1.25 percent per year—was less than the 1.75 annual rate that he had previously charged Hays to manage her assets when they were invested in mutual funds.

The Supreme Judicial Court rejected this argument, however, reasoning that Ellrich was motivated at least in part by the potential for a long-term increase in his investment advisory fees if he could raise the funds necessary to launch the hedge fund. Although observing that personal financial gain is clearest in cases where the defendant receives a commission or other direct compensation, the court agreed with the trial court's finding that Ellrich viewed the hedge fund as an "opportunity" for him in part because he expected that, if the fund proved viable, the fund would attract additional investments and ultimately grow Ellrich's advisory fees.

Statute of limitations. The state high court also rejected Ellrich's argument that the Act's four-year statute of limitations period began to run in December 2000, when information in the offering memorandum should have put Hays on inquiry notice that the investment was unsuitable. As Hays's investment adviser, Ellrich owed her a fiduciary duty, and this made all the difference in determining when the statute of limitations clock began to run, the court stated.

Under the "fraudulent concealment" doctrine codified in Massachusetts law, a fiduciary's failure adequately to disclose the facts that would give rise to knowledge of a cause of action is equivalent to fraudulent concealment. In these cases, the statute of limitations clock begins to run only when the plaintiff has actual knowledge of the facts giving rise to her causes of action. Where an investment adviser owes a fiduciary duty of disclosure to his or her client and violates the Act by misleading the client regarding the suitability of an investment, therefore, the limitations clock begins to run only when the client has actual knowledge of the unsuitability of the investment.

In the context of this case, the court continued, the limitations clock for Hays began when she had actual knowledge of the unsuitability of the hedge fund interests—for instance, knowledge that investing in the fund was substantially riskier than the investments that Ellrich had previously made for her. The trial court had found that without expert advice, a reasonable client in Hays's position could not have ascertained how the hedge fund's

risk compared to the risks she had been taking historically. The trial court also found that a reasonable investor would not have noticed that something was amiss prior to September, 2003, when Ellrich informed Hays that the fund was insolvent and that an investigator from the Massachusetts Securities Division would be contacting her. As these findings were not clearly erroneous, the Supreme Judicial Court affirmed the ruling below.

Weight of the evidence. The state high court quickly dispensed with Ellrich's remaining arguments that the judgment was contrary to the great weight of the evidence. The court found that the evidence was more than sufficient to support the trial judge's finding that Ellrich's misrepresentations and omissions were material in that they strongly suggested that the hedge fund was a suitable investment for Hays to invest three-quarters of her retirement savings, where it was not. Even if it were to accept Ellrich's argument that the offering memorandum contradicted or corrected all his false oral assertions and omissions, the court concluded that that would not negate the materiality of his oral statements. Given the long-standing relationship of trust between Ellrich and Hays, Hays reasonably viewed Ellrich's advice regarding suitability as significantly altering the "total mix" of information available to her.

Attorneys: Patrick J. Dolan (Perry, Krumsiek & Jack LLP) for Molly A. Hays; David B. Mack and Stephanie R. Parker (O'Connor, Carnathan & Mack, LLC) for David J. Ellrich and Morgan Financial Advisors, Inc.

Companies: Morgan Financial Advisors, Inc.

The case is No. SJC-11743.

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