73459-8

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NO. 73459-8

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION I

DONALD BURDICK, et al.,

Plaintiffs/Appellants,

v.

ROSENTHAL COLLINS GROUP, LLC,
an Illinois limited liability corporation,

Defendant/Appellee.

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On Review from King County Superior Court
Case No. 12-2-28409-1 SEA (Hon. Douglass A. North)

OPENING BRIEF OF APPELLANTS

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4. The trial court erred by granting Rosenthal Collins's motion for a protective order that prohibited discovery concerning its monitoring and review of the account where the customers' money was being traded.

II. ISSUES PERTAINING TO ASSIGNMENTS OF ERROR

It is uncontested that Enrique Villalba defrauded his customers by selling them a program that promised their money would be invested in treasury bills except for three to five times a month when he would supplement the return on those investments by using his expertise to trade futures contracts with "little or no leverage" and "minimal risk" to the underlying assets. Instead, Villalba used the program to trade almost daily in the account with high-leveraged, risky futures trades that he hid from his customers by sending them phony account statements. The customers lost all the money they invested in the program.

Issue 1: Under section 1707.43 of the Ohio Securities Act, persons other than the seller of the securities can be liable for the seller's violations of the Act if they "participated in or aided the seller in any way" in the illegal sales. Is Rosenthal Collins liable under this section where: (1) it knew that Villalba was legally prohibited from either operating or soliciting money for his planned commodity pool, yet it opened the account for him to do so even though its own rules forbid opening an account when illegal activity is suspected; (2) it knew that the offering circular used to solicit money for the commodity pool misrepresented the risks of Villalba's program and futures trading in general but opened the account despite the requirement that an account should not be opened when misrepresentations are made in an offering circular for the account; (3) it knew that Villalba represented to investors that he would trade only a few days a month in "unleveraged" futures transactions but took no action to stop trading when its records showed that Villalba was trading almost daily, speculating with high-leverage transactions, and materially deviating from the investment plan; and (4) its reporting systems detected substantial suspicious activity in the account that was not reported or acted upon by its compliance department even though it was required to close an account if suspicious activity was detected? (Assign. of Error 1.)

Issue 2: Under RCW 21.20.430(1) of the Securities Act of Washington, liability may be imposed on a person in addition to the immediate seller if that person's participation was a substantial contributive factor in the violation. Is Rosenthal Collins liable under this section based on the circumstances stated in Issue 1? (Assign. of Error 1.)

Issue 3: Under RCW 21.20.430(3) of the Securities act of Washington, liability may be imposed on a person who "materially aids in the transaction" that violates the Act. Is Rosenthal Collins liable under this section based on the circumstances stated in Issue 1? (Assign. of Error 1.)

Issue 4: Did the court err in holding as a matter of law that customer Goldberg did not purchase securities when he (1) invested funds directly into Villalba's program, (2) had no control over Villalba's investment decisions, (3) was not aware of the actual transactions made in the account, and (4) paid Villalba a percentage of the profits in his program – as did the other customers – but where Villalba was compensated through a partnership agreement with Goldberg? (Assign. of Error 2.)

Issue 5: Is Rosenthal Collins liable to Villalba's customers for negligent supervision of Villalba's account based on the circumstances stated in Issue 1 and where Rosenthal Collins's conduct also violated CFTC and NFA regulations and its internal compliance procedures? (Assign. of Error 3.)

Issue 6: Did the court err by granting Rosenthal Collins's motion under the Bank Secrecy Act for a protective order prohibiting the customers from seeking any information regarding its review and monitoring of Villalba's account (1) when disclosure of that information was expressly allowed by the Act and (2) even though that information had been provided to counsel in other litigation and disclosed in a public order issued by the CFTC? (Assign. of Error 4.)

III. STATEMENT OF THE CASE

Introduction. This appeal addresses summary judgment dismissal of securities and negligence claims brought against defendant/respondent Rosenthal Collins Group, LLC ("RCG") for its role in connection with a fraud perpetuated by Enrique Villalba. Relief is also sought from a protective order obtained by RCG that prohibits discovery of its role in monitoring the account involved in the fraud.

RCG opens the MMA account. RCG is a Futures Commission Merchant ("FCM") registered with the Commodities Futures Trading Commission ("CFTC") and the National Futures Association ("NFA") to conduct trading of futures contracts. CP 1522. In 1998, RCG agreed to open a trading account for Money Market Alternative, LLC ("MMA") a company owned by Villalba. CP 349, 840-45.

Villalba describes his "low risk" program to RCG. RCG reviewed a six page offering circular Villalba prepared to solicit $100 million from investors for the MMA account. CP 349-51. The circular described the investment plan for the account:

(1) Funds from Villalba's customers would be pooled to invest in treasury bills or money market funds "within a vehicle similar to a mutual fund." CP 853.

(2) On occasion, Villalba would purchase S&P 500 futures contracts. The timing of these purchases were based on his purported expertise in predicting certain market trends. CP 856-57. Those transactions would add 2% to 5% additional value for his customers. CP 856.

(3) The investment had minimal risk because the futures transactions would be made with "little or no leverage." *Id.*

(4) Risk in the futures trading would be further limited by the use of stop orders set to limit losses. *Id.*

(5) The trades in futures contracts would be infrequent, described variously as "a few days per month a position in the Standard & Poor's 500 Index is taken," "on average a week per month," and "approximately 90% of the year, the asset value of the portfolio will not fluctuate on a daily basis as the dollars in the portfolio will remain in non-fluctuating treasury bills or short term commercial paper." Accordingly, "underlying asset risk is

minimal." CP 856.

The program created a commodity pool. The circular claimed that the fund was not subject to state or federal regulation. CP 856. RCG, however, recognized that the account would become a commodity pool, the futures industry's equivalent of a mutual fund. CP 1556. That made Villalba, or his company, a commodity pool operator. *See* CP 849. Neither were registered as commodity pool operators as required by the CFTC. CP 845, 851.

The attempt to avoid registration. A form was provided to Villalba with the new account documents identifying two potential exceptions to the registration requirement. CP 849. RCG's file shows that Villalba selected an exemption that was only applicable if he neither (1) received any direct or indirect compensation for managing the anticipated $100 million pool nor (2) advertised for participants. *Id.* The circular, however, stated that (1) he expected to receive management fees from the proceeds, CP 855, and (2) MMA would be "offering these securities to the public." CP 853.

RCG's compliance procedures mandate that a new account should not be opened if it suspects illegal activity. CP 1539. After its reviews of the offering circular and the other information provided by Villalba, it opened the MMA account for trading. *See* CP 1524. That decision would generate more than $1 million in commissions and fees for RCG. CP 1525, n.6.

The MMA plan was never followed. Villalba never followed his purported investment plan. *See* CP 1517-20. Instead of keeping customer money in treasury bills with occasional transactions in S&P 500 futures contracts, Villalba traded futures with RCG almost daily. *E.g.,* CP 1406-08, 1413-14, 1473-75. Also, the trades were highly leveraged and risky. The promised "stop orders" to limit losses were not used. CP 449. Single day losses of more than $100,000 were not uncommon, and in March 2008, the MMA account lost more than $9 million during the month. CP 1459.

Although RCG's records showed the losses and frequency of trading in the commodity pool, the quarterly statements provided to the customers did not. *See*, CP 1129, (customer statement for January-March 2008). Villalba fabricated account statements showing that his program was doing well. CP 1119, 1129. When Villalba revealed his fraud to the customers, their account statements indicated an aggregate value of millions of dollars. In actuality, the customers' money was gone. *Id.*

Villalba's customers lose $30 million. The 26 victims of the MMA fraud lost more than $30 million. CP 295-97. They include customers/appellants Donald Burdick, Bernard Goldberg, Susan Byington, Lisa Carfagno, Peter and Janice Elliot, Paul Golstein, Tom and LaVoe Mulgrew, Susan Rosen, Martin Silverman, Sharon Silverman, and Barry and Robin Stuck, who received descriptions of the program promising their money would reside in treasury bills or money market except for a "few days" during a month when the "portfolio seeks to capture a small 1% gain ... via the use of the S&P 500 index contract," thus providing a "double-digit rate of return without the same market risk associated with diversified stock or bond portfolios ...." CP 1625.

Villaba sent to prison. Villalba was sued by the Securities and Exchange Commission and the CFTC. CP 1362-84. He pled guilty to wire fraud, was ordered to pay more than $30 million in restitution, and is serving a 105 month prison sentence. CP 292-97.

The CFTC investigates RCG. Shortly after Villalba was convicted, the CFTC investigated RCG's role in Villalba's fraud, concluding that RCG failed to properly supervise the MMA account. CP 1522-32. The CFTC found that RCG ignored many "red flags" appearing in the account records and that it should have acted in light of "the lack of regard for trading losses, commissions, and fees in the MMA account." CP 1527-28.

Related litigation. RCG was sued by Villalba's customers in two other cases, both in Ohio: *Pieretti v. RCG Group, LLC*, No. 2011-CV-0051 (Erie County) and *VASA Order v. RCG Group, L.L.C.* No. CV-11-753705 (Cuyahoga County). RCG brought motions for summary judgment in both cases. Some claims were dismissed, but both courts refused to dismiss the claims for secondary liability under the Ohio securities act. App. A, C. The

VASA case went to trial solely on the Ohio securities claims. The jury returned a verdict in favor of the plaintiffs. App. E.

Procedural history of this case. The customers filed a motion for summary judgment that their transactions with Villalba were securities under the state securities acts. The trial court granted that motion except for the investments made by customer Bernie Goldberg. The court held that his investments were not securities because Villalba was compensated through a partnership agreement he had with Goldberg. RCG filed two summary judgment motions. The first sought a holding that claims for some transactions were barred under the Ohio and California statutes of repose. The customers conceded the claims under California's securities act, but contested the applicability of the Ohio provision. That motion was not decided because the trial court granted RCG's second motion for summary judgment, where it: (1) ruled that all of the customers could bring claims under the Ohio securities act, (2) held that the purchases made by the plaintiffs were securities, except for customer Goldberg, (3) dismissed the customers' securities claims, holding that RCG could not be secondarily liable for Villalba's violations of the securities acts, and (4) dismissed the customers' claim for negligent supervision of the account and the Washington Consumer Protection Act claim. The trial court did not rule on

RCG's claim that the state securities acts were preempted by the Commodities Exchange Act.

Prior to the summary judgment motions, the trial court granted RCG's motion for a protective order that the federal Bank Secrecy Act prohibited discovery of its monitoring and investigation of the MMA account.

IV. ARGUMENT

A. Villalba illegally sold securities to the customers that violated the Ohio and Washington securities acts

1. Introduction: the customers' securities claims.

RCG is secondarily liable to the customers under the Ohio and Washington securities acts for its role in Villalba's fraud.[1] The customers can recover their losses under these acts by showing (1) that they purchased "securities"; (2) that Villalba violated the securities laws when he sold those securities to the customers, and (3) that RCG's involvement with the scheme was sufficient for secondary liability under either (a) the Ohio standard of "participated in" or "aided the seller in any way," or (b) the Washington standard of "substantially contribute" to the violation or "materially aid" the transaction.

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[1] Claims were also filed under the California securities act on behalf of customers who were California residents. Those claims are not being pursued because their claims under the Ohio act provide adequate relief. Claims under the Washington statute are still being pursued because RCG claimed that certain of Washington resident Goldberg's transactions were barred by the Ohio act's statute of repose that would not be barred under the Washington statute. That issue was not resolved by the trial court. CP 2378 (¶ 2).

These claims were dismissed on a motion for summary judgment. Review by this court is *de novo*.[2] All facts and reasonable inferences are viewed in the light most favorable to the non-moving party.[3] When reasonable minds could differ, the motion should be denied and the case should go to trial.[4]

2. The customers were sold "securities."

The trial court granted the customers' motion for summary judgment ruling that the customers purchased securities when they provided money to Villalba's Money Market Alternative ("MMA") program.[5] RCG did not appeal that decision.

3. Villalba violated the Ohio and Washington securities acts when he sold securities to the customers.

Villalba sold unregistered securities to the customers,[6] thus violating the Ohio and Washington securities acts.[7] The acts were also violated by

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[2] *Cornish Col. of the Arts v. 1000 Virginia L.P,* 158 Wn. App. 203, 215-216 (2010).

[3] *Kahn v. Salerno*, 90 Wn. App. 110, 117 (1998), rev. denied, 136 Wn.2d 1016.

[4] *Klinke v. Famous Recipe Fried Chicken, Inc.*, 94 Wn.2d 255, 256-257, (1980).

[5] CP 1014-31; CP 2378-79 (¶ 3); RP 24. The trial court incorrectly ruled that customer Bernie Goldberg did not purchase securities when he made payments to MMA because he used a partnership agreement to compensate Villalba for his investments with MMA. That error is addressed in part C of the Argument.

[6] CP 1542.

[7] Ohio act: O.R.C. § 1707.44(C)(1); *Murphy v. Stargate Def. Sys. Corp.*, 498 F.3d 386, 392 (6th Cir. 2007) (rescission available to purchaser of unregistered securities under Ohio securities act). Washington act: RCW 21.20.140; *Christgard, Inc. v. Christensen*, 29 Wash. App. 18, 26, 627 P.2d 136, 141 (1981) (rescission available to purchaser of unregistered securities under Washington securities act).

Villalba's misrepresentations to the customers.[8] Villalba promised a fund principally invested in treasury bills but instead pooled customers funds to invest exclusively in high-risk, highly-leveraged futures contracts and created phony account statements that hid the disastrous results. He pled guilty to a federal wire fraud charge, was ordered to pay restitution of more than $30 million, and is serving a 105 month prison sentence. His fraud against the customers is uncontested.

B. RCG is liable under the securities acts of Ohio and Washington for its role in Villalba's MMA scam.

1. RCG is liable under the Ohio Securities Act because it "participated in or aided" Villalba's scheme to speculate in an illegal commodity pool while representing to customers that their money was invested in treasury bills.

Ohio extends secondary liability for securities violations to those who "participated in" the illegal sale or "aided the seller in any way":

> Every sale or contract for sale made in violation of Chapter 1707 of the Revised Code is voidable at the election of the purchaser. The person making such sale or contract for sale, ***and every person who has participated in or aided the seller in any way in making such sale or contract for sale, are jointly and severally liable to such purchaser***, ... for the full amount paid by such purchaser and for all taxable court costs, unless the court determines that the violation did not materially affect the protection contemplated by the violated provision.[9]

[8] Ohio act: O.R.C. § 1707.44(B)(4) (false representations); O.R.C. § 1707.44(G) (fraudulent acts or practices). Washington act: RCW 21.20.010 (schemes to defraud, untrue statements of material fact).

[9] O.R.C. § 1707.43 (emphasis added).

This provision "does not require that a person induce a purchaser to invest in order to be held liable. Rather, the language is very broad, and participating in the sale or aiding the seller in any way is sufficient to form a basis for liability under R.C. 1707.43."[10] "The statute does not require knowledge, intent, or any other mental state on the part of secondary actor, nor does it require reliance, inducement, or proximate cause as between the secondary actor and purchaser."[11] And "any kind of aid will do."[12] In an early decision under the act, a court held that signing a stock certificate qualified as the type of aid that satisfied the statute.[13]

The selling point of Villalba's MMA program was his purported skill in using "non-leveraged" S&P 500 futures contracts at select times to increase returns from investments in money market funds or treasury bills. As it turned out, Villalba pooled the customers' money to trade highly-leveraged

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[10] *Federated Mgt. Co. v. Coopers & Lybrand*, 137 Ohio App. 3d 366, 391, 738 N.E. 2d 842, 861 (2000).

[11] *In re Nat'l Century Fin. Enterprises, Inc., Inv. Litig.*, 755 F. Supp. 2d 857, 884 (S.D. Ohio 2010).

[12] *Pieretti v. RCG Group, LLC,* Erie C. P. No. 2011-CV-0051, Opinion and Judgment Entry at 6, 8 (April 16, 2013) (denying summary judgment in concluding that a jury could reasonably conclude that RCG undertook an "indispensable role" in Villalba's "fraudulent offering of securities that was to extend well into the future"). Ohio trial court opinions are cited by appellate courts as authority. *See, White v. Am. Mfrs. Mut. Ins. Co.*, 2002-Ohio-4125, ¶ 30 (Ct. App.); *Preferred Capital, Inc. v. Power Eng'g Grp., Inc.*, 163 Ohio App. 3d 522, 531, 839 N.E.2d 416, 423 (2005) (quoting Cuyahoga trial court opinion on forum selection clauses). "All opinions of the courts of appeals issued after May 1, 2002 may be cited as legal authority and weighted as deemed appropriate by the courts without regard to whether the opinion was published or in what form it was published." Ohio S. Ct. Rep. Op. Rule 3.4.

[13] *Miller v. Griffith*, 196 N.E.2d 154 (Ct. Com. Pl. 1961).

positions in futures contracts at high risk for the chance of substantially higher returns that would allow him to pay himself significant fees while providing customers with the smaller return described in his offering materials.[14] To accomplish his plan he needed a licensed FCM willing to establish a commodity pool.[15] RCG stepped up. Without a willing FCM, Villalba could not pursue his MMA program.

The court in *Pieretti* found that RCG could be liable under O.R.C. § 1707.43 because it assisted in making Villalba's sale of securities possible, even if it did not help promote those sales.[16] That is also true under North Dakota's securities act, which also extends liability to persons "who shall have participated or aided in any way in making such sale":[17]

> Participation is not necessary, under the statute, to render corporate directors liable where they aided in any way in making illegal sales of securities of the kind involved in a particular sale ***if such aid made the particular sale possible***.[18]

Similarly, the Ohio Court of Appeals held that a financial firm could have secondary liability under section 1707.43 when it agreed to provide a line of credit that needed to be established before an issuer was allowed to

[14] CP 1517-22.

[15] CP 1552 (p. 197).

[16] *Pieretti*, Apr. 16, 2013 Order at 7-8.

[17] *Schollmeyer v. Saxowsky*, 211 N.W.2d 377, 386 (N.D. 1973).

[18] *Id.* at 387 (emphasis added). *See*, Long, 12A Blue Sky Law (2010), pp. 9-185 ('Aiding ...' focuses upon activities which do not directly lead to the sale, but make it possible). *Sherter v. Ross Fialkow Capital Partners, LLP*, 2013 WL 1324818, *7 and 12 (Mass. Super. 2013) (applying "making the sale possible" test for "materially aids in the sale").

sell notes to investors. In *Federated Mgt. Co. v. Coopers & Lybrand*,[19] a company called mid-American Waste Systems, Inc. ("MAW") sought to refinance debt by issuing commercial notes.[20] As a condition of the note offering, MAW was required to secure a $75 million line of credit. NatWest USA issued a commitment letter agreeing to be the agent bank for that line of credit, subject to its review of environmental matters.[21] MAW prepared a prospectus to offer its notes for sale, which included its financial statements. NatWest's internal review of those statements concluded that estimates for landfills were understated by over $130 million.[22] Nonetheless, NatWest went forward with its commitment to provide a line of credit. As a result, 20% of the proceeds received by the underwriters from the note sales was paid to NatWest as a fee.[23] NatWest did not disclose its conclusions to the underwriters or anyone else. Less than two years later, MAW defaulted on the notes and later filed for bankruptcy. Trustees for the noteholders sued NatWest for secondary liability under the Ohio Securities Act for the issuer's misrepresentations.

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[19] *Federated Mgt.*, 137 Ohio App. 3d 366, 738 N.E. 2d 842 (2000).
[20] *Id.* at 850.
[21] *Id.* at 848.
[22] *Id.* at 854.
[23] *Id.* at 858.

The trial court dismissed the claims against NatWest, which the trustees appealed. NatWest argued that as a lending institution it had no duty to disclose information about its customer [MAW] to third parties or to the investors, emphasizing that it had no relationship at all with any investor.[24] NatWest also asserted that it had nothing to do with promoting the sale of the notes and that its limited review of MAW's prospectus was solely to determine whether to provide the line of credit.[25]

The court concluded that NatWest's involvement was sufficient to support secondary liability under the Ohio act. "R.C. 1707.43 is very broad and only requires a determination that a person participated or aided "in any way." "R.C. 1707.43 uses very broad language and in addition to this, the securities laws are to be liberally construed."[26]

Thus, NatWest's willingness to provide a commitment for a line of credit that was needed so that a sale of securities could proceed was found sufficient for secondary liability to the purchasers of the notes.

Similarly, RCG's willingness to provide the commodity pool needed for Villalba's sales of securities to proceed makes it liable under O.R.C. § 1707.43. This is particularly true because, as shown next, no FCM should ever have allowed this account to exist. Villalba needed the participation

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[24] *Id.* at 854.
[25] *Id.* at 860.
[26] *Id.* at 861.

and aid of a FCM who was willing to ignore the law and bend its own rules for Villalba's scheme to succeed. That willing FCM was RCG.

a) RCG's participation and aid to the scheme was shown by its willingness to provide Villalba with the commodity pool he needed to trade futures contracts for his scheme, even though the arrangement was illegal and prohibited by RCG's own internal procedures and CFTC and NFA regulations.

RCG's registration with the CFTC and the National Futures Association ("NFA") allows it to handle transactions in futures contracts subject to the rules and regulations of those agencies and the procedures and rules that RCG was required by law to establish. Among other things, RCG is required to carefully review information provided when a potential client seeks to open an account to trade futures.[27] If the information regarding the account is suspicious, RCG is required to refuse to open the account.[28]

The information provided to RCG from Villalba should have immediately caused concern. The account opening documents describe MMA's business as a "money management"[29] and Villalba as a "portfolio manager"[30] and include a six-page superficial MMA "securities" offering circular seeking $100 million from investors with an investment plan that

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[27] CP 1540 (must "know your customer").

[28] CP 1539 (Tanzar Dep. at 80) ("the FCM has the right and the duty to refuse to accept an account if it suspects that illegal activity is being conducted.")

[29] CP 845.

[30] CP 851.

requires expertly-timed trades in futures contracts.[31] However, the account forms show that Villalba was not registered with the CFTC or the NFA to sell futures contracts[32] and there was no indication in the file that he was registered to sell securities in any state.[33]

Further, the investment plan described in the offering circular showed that MMA intended to aggregate investor contributions into a common fund for trading.[34] RCG recognized that this meant Villalba's program involved transactions in a commodity pool.[35] Commodity pools are "the commodity-futures equivalent of a mutual fund."[36] Because Villalba was soliciting money for a commodity pool, he was a commodity pool operator.[37]

Commodity pool operators must be registered.[38] Registration of commodity pool operators is not a mere formality; it protects investors:

> One of the ways in which unsophisticated traders have lost substantial amounts of money is through commodity advisors and commodity pool operators. This bill will provide for the registration of all such persons, establish procedures under which they will be permitted to operate and specifically

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[31] CP 852-59.

[32] CP 845; CP 851.

[33] *See*, CP 839-68 (the MMA account opening documents. CP 403, ¶ 24).

[34] CP 856.

[35] *See*, CP 1556 (Montgomery Dep.); CP 1546 (Tanzar Dep., pp 138-40); CP 394 (¶ C.2.a).

[36] *CFTC v. Equity Fin. Group LLC*, 527 F.3d. 150, 160 (3d. Cir. 2009).

[37] *See* 7 U.S.C. § 1a(11).

[38] 7 U.S.C. § 6m. ("It shall be unlawful for any commodity trading advisor or commodity pool operator, unless registered under this Act [7 USCS §§ 1 et seq.], to make use of the mails or any means or instrumentality of interstate commerce in connection with his business as such commodity trading advisor or commodity pool operator ....")

> eliminate certain undesirable practices which have enticed unsuspecting traders into the markets with, far too often, substantial loss of funds.[39]

The new account information provided to RCG, however, stated that neither Villalba nor MMA were registered with the CFTC as a commodity pool operator.[40] Villalba's plan to establish a commodity pool was unlawful, and RCG was required to refuse to open the account unless Villalba became registered. Registration, however, would require Villalba to provide extensive information on his program to the CFTC including the nature of his business, his manner of giving advice and rendering analysis, his scope and authority over clients' funds and accounts, and other information that would have enabled the CFTC to examine him and his program to determine whether registration is appropriate.[41]

A way around the registration requirement was to have Villalba declare he did not have to register a as a commodity pool operator under §4.13 of the CFTC regulations. A form was included with the new account documents that identified two exemptions available under that regulation.[42] Section §4.13(a)(1) was chosen:

> A person is not required to register under the Act as a commodity pool operator if:

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[39] *CFTC v. Equity Fin. Group LLC*, at 157 (quoting H.R. Rep. No. 93-975, at 79 (1974)).
[40] CP 845; CP 851.
[41] *See*, 7 U.S.C. § 6n.
[42] CP 849.

> (i) ***It does not receive any compensation or other payment, directly or indirectly***, for operating the pool, except reimbursement for the ordinary administrative expenses of operating the pool;
>
> (ii) It operates only one commodity pool at any time;
>
> (iii) It is not otherwise required to register with the Commission and is not a business affiliate of any person required to register with the Commission; and
>
> (iv) ***Neither the person nor any other person involved with the pool does any advertising*** in connection with the pool (for purposes of this section, advertising includes the systematic solicitation of prospective participants by telephone or seminar presentation).[43]

This exemption was not intended for commercial commodities pools such as the one proposed for the MMA account:

> The Commission proposed and adopted Rule 4.13(a)(1) with the primary intention of exempting from CPO registration "those pool operators whose operation of commodity pools is limited to … pools that are essentially clubs or family groups (and that meet other specified conditions)."[44]

RCG did not have to go beyond the account opening documents to know that Villalba could not meet the requirements for this exemption. Villalba was not seeking to open a small investment club or family account where he would receive no compensation. His submissions to RCG show that he and MMA were in the business of managing money and expected to be paid

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[43] 17 C.F.R. § 4.13(a)(1) (emphasis added).

[44] CFTC no action response 99-23, 1999 CFTC Ltr. LEXIS 20, *8-9, Comm. Fut. L. Rep. (CCH) ¶27,674. *See*, 50 FR 15868 (1985) (Rule 4.13 "exempts the operators of essentially family, club and small pools from registration as a [commodity pool operator].")

for doing so. The offering circular confirmed he would be paid management fees.[45] And the existence of the offering circular itself was contrary to the proscription against advertising. It showed that Villalba intended to systematically solicit prospective participants for the pool.[46]

The exemption was not treated seriously. No evidence has been produced showing this exemption was filed with the NFA or CFTC. Even if an exemption had been filed, it could not become effective until a notice of the exemption was provided to potential participants in the commodities pool describing the consequences of the exemption to the participant.[47] This notice was required to be given before the participants signed an agreement with MMA. A copy of the notice was required to be filed with both the NFA and the CFTC.[48] The customers never received that notice and had no idea that they were investing in a commodity pool.

In short, the claimed exemption was illegal on its face and none of the steps needed to validate the exemption were even attempted.

RCG not only had to be willing to ignore CFTC statutes and regulations to open the MMA account, it had to be willing to breach NFA Bylaw 1101,

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[45] CP 855.

[46] CP 853 ("This offering is not underwritten. The L.P. is offering these securities to the public solely through its Members on a best-efforts basis.")

[47] *See* CP 849, which is the RCG form of a notice that should have gone to participants, the CFTC, and the NFA.

[48] 17 C.F.R. § 4.13(a)(6).

which prohibits NFA members (such as RCG) from doing business with customers who should be registered but aren't. Under Bylaw 1101, when an account is controlled by a third-party who is not registered, RCG "should inquire as to the basis of any exemption and, if applicable, should verify that account controller has made the required filings with the CFTC and NFA." And for a commodity pool operator who claims to be exempt from registration, RCG "should verify that the customer has made the required filings with the CFTC and NFA."[49] Those reviews should be documented.[50] There is no evidence this was done.

RCG's willingness to sweep aside the statutes, regulations, and rules intended to protect investors from this type of fraud so that it could do business with Villalba rises to the level of participation or aid adequate for secondary liability under the Ohio act.

b) RCG assisted Villalba by its willingness to open an account for him despite the misrepresentations in the offering circular for the account that should have prevented the account from being opened under RCG's compliance procedures.

The offering circular in RCG's possession contained misrepresentations being made to potential investors to raise money for the account. The *Pieretti* court held a jury could reasonably conclude that the Circular

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[49] NFA Interpretive Notice 9007 – Compliance with NFA bylaw 1101 (1987, revised July 1, 2000).
[50] *Id.*

contained several material misrepresentations that RCG should have detected during its review, including a (1) claim that the fund was not subject to regulation by any federal or state agency, even though the commodity pool is subject to CFTC regulation and the sales of securities through the offering circular were regulated by state and federal securities agencies, (2) that MMA would purchase "S&P 500 index futures contracts with little or no leverage, when futures contracts "typically have the leverage of 10:1," and (3) that the "underlying risk is minimal," even though RCG's own risk disclosure statement states that "[t]ransactions in futures carry a high degree of risk."[51]

RCG's litigation expert also recognized that the contemplated trading was "very risky" and assumed (incorrectly) that the circular would disclose that the investors could lose their entire investment.[52] He also acknowledged that RCG should not have opened the MMA account if the offering circular included materially false statements.[53] It did, and the account should not have been opened. RCG bent its rules to assist Villalba.

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[51] *Pieretti*, Apr. 16, 2013 Order at 8.
[52] CP 1549 (Tanzar Dep at. 182-83, 185).
[53] CP 1543 (Tanzar Dep.).

c) RCG should have terminated the MMA account because of numerous regulatory "red flags" in the account and Villalba's indifference to the millions of dollars of losses and high commissions building up in the account and its failure to do so aided Villalba in his scheme.

The CFTC noted that "RCG's compliance procedures set forth multiple methods for RCG to detect suspicious account activity."[54] Those procedures included monthly report showing deposits and disbursements over certain amounts, and suspicious money transfers. Under RCG compliance procedures, "red flags" "that may be indicative of suspicious activity include … a customer's "noticeable lack of regard for amount of commissions, profitability of trades, or level of fees."[55] Once suspicious activity appears, RCG is obligated to stop trading and close the account. With the MMA account, however those red flags and signs of suspicious activity were ignored. No RCG officer or employee or agent reported any suspicion regarding the MMA account to its compliance department. [56]

RCG was also required to detect deviations between the investment plan in the offering circular and actual trading and close the account if there was a material deviation.[57] Monthly statements for the MMA account showed

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[54] *In the matter of: RCG Group, LLC*, 2012 CFTC LEXIS 26, Comm. Fut. L. Rep. (CCH) ¶32,166, Order, Instituting Proceedings Pursuant to Section 6(c) and (d) of the Commodity Exchange Act, As Amended, Making Findings and Imposing Remedial Sanctions (April 12, 2012) ("2012 CFTC Order") at CP 1524.

[55] 2012 CFTC Order at CP 1525.

[56] *Id.* at CP 1525-26.

[57] CP 1553 (page 202).

that Villalba had abandoned the investment plan. The activity in the account was vastly different than represented. Money from existing and new customers poured into the MMA account as RCG ignored numerous signs of suspicious activity.

RCG's failure to follow its own internal policies and procedures facilitated Villalba's ongoing fraud and evidenced its participation with and aid to Villalba in his securities violations.[58]

d) As recognized by two Ohio courts, on these facts a jury could reasonably find that RCG participated in or aided Villalba's fraudulent sale of securities under Ohio law.

RCG sought summary judgment in the two Ohio courts handling claims arising from the MMA account. As here, RCG contended that it could not be liable unless it directly participated in the sale, arguing that it only "provided administrative or operation services necessary for MMA to trade commodities" and that "such conduct was separate and removed from the actual making of the sale."[59]

The *Pieretti* court rejected these arguments: "any kind of aid will do. Liability is not dependent on whether Defendants helped induce the purchaser to invest."[60] "Villalba may not have been able to sell the securities

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[58] *See, McAdam v. Dean Witter Reynolds, Inc.*, 896 F.2d 750, 754 (3d Cir. 1990) (brokerage firm and bank facilitated a scheme "by failing to follow their own internal policies and procedures.").
[59] *Pieretti*, Apr. 16, 2013 Order at 2.
[60] *Id.* at 6-7.

to Plaintiffs unless RCG agreed to be MMA's future commission merchant. RCG opened, maintained, and serviced the futures trading account for MMA. Such activities by RCG may have made the sale of the securities possible."[61] Thus, a jury "could reasonably conclude that RCG knowingly undertook an indispensable role in the fraudulent offering of securities that was to extend well into the future."[62]

The *VASA* court denied the summary judgment motion on the Ohio securities claim without an opinion,[63] but in denying RCG's earlier motion to dismiss the securities claim agreed that "R.C. 1707.43 does not require that a person induce a purchaser to invest in order to be held liable. Rather, the language is very broad, and participating in the sale or aiding the seller ***in any way*** is sufficient to form a basis for liability under R.C. 1707.43."[64] Just prior to trial, the *VASA* court denied RCG's motion *in limine* to exclude evidence of trading in the account and failing to monitor the account because "[t]hat conduct, if proven, can fall within the rubric of 'aiding and abetting.'"[65]

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[61] *Id.*

[62] *Id.* at 8.

[63] Journal Entry September 25, 2015 ((dismissing all claims except for "aiding and abetting securities fraud under R. C. 1707.43.)

[64] *VASA Order v. RCG Group, L.L.C.*, 2013 Ohio Misc. LEXIS 3, *15 (Ohio C.P. Jan. 29, 2013) (emphasis in original).

[65] Journal Entry, September 26, 2015.

2. RCG is liable under the Securities Act of Washington because it "substantially contributed" to the sale of the securities and "materially aided Villalba.

Washington customers have claims against RCG under two separate provisions of RCW 21.20.430, which provides civil liability and damages for violations of the WSSA. First, RCG is liable under RCW 21.20.430(1):

> Any person, who offers or sells a security in violation of any provisions of RCW 21.20.010, 21.20.140 (1) or (2), or 21.20.180 through 21.20.230, is liable to the person buying the security from him or her, who may sue either at law or in equity to recover the consideration paid for the security ....[66]

This section is triggered by Villalba's violation of RCW 21.20.140 (selling unregistered securities) and RCW 21.20.010 (misrepresentations and fraud in selling securities).

Under the WSSA "liability may be imposed on a person in addition to the immediate seller if the person's participation was a substantial contributive factor in the violation."[67] RCG argued under *Hines v. Data Line Systems, Inc.*,[68] that it could not be a substantial contributor to the violation because it was only a "service provider" that executed trades in the account. The court in *Hines* held that a law firm that provided legal services by giving advice to its corporate client was not a "seller" of securities. RCG claims

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[66] Relevant part quoted, damages section omitted.

[67] *Haberman v. Wash. Pub. Power Supply Sys.*, 109 Wn.2d 107, 130, 744 P.2d 1032, 1051 (1987), *quoting with approval* comment on Uniform Securities Act § 605.

[68] *Hines v. Data Line Systems, Inc.*, 114 Wn.2d 127, 149 (1990).

that as a fellow "service provider" it also cannot be considered to have been a substantial contributing factor to Villalba's sales because it did not act to promote the sale. RCG is not immune from liability under *Hines*.

First, *Hines* does not exclude all "service providers" from liability. The case is frequently distinguished "because the statements at issue consisted of legal advice presented only to the corporate client. Moreover, the law firm that provided the advice explicitly barred investors from relying on their statements."[69] Accountants and auditors are frequently found to be liable as sellers because they assume "a *public responsibility transcending any employment relationship with the client*."[70]

Second, RCG is not simply a "provider of services" to a client. It created an account eligible as a commodity pool to help Villalba sell his program. As a registered seller of investments, it was required to examine the account opening information from Villalba to ensure the account could be opened in compliance with CFTC and NFA regulations, which exist to protect investors. And unlike the lawyers in *Hines*, it directly benefited from commissions for trading from funds invested by the customers. RCG was a catalyst to the sale and a substantial contributor to Villalba's scheme. It is

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[69] *In re Metro. Sec. Litig.*, 532 F. Supp. 2d 1260, 1301 (E.D. Wash. 2007).

[70] 532 F. Supp. 2d at 1301 (emphasis in original). *See FutureSelect Portfolio Mgmt., Inc. v. Tremont Grp. Holdings, Inc.*, 180 Wn.2d 954, 972, 331 P.3d 29, 38 (2014) (auditor potentially liable because investor would not have invested unless funds were audited by the defendant).

liable as a "seller" under RCW 21.20.430(1).

RCG is also liable RCW 21.20.430(3) because it "materially aided" Villalba's transactions:

> … every broker-dealer, salesperson, or person exempt under the provisions of RCW 21.20.040 who materially aids in the transaction is also liable jointly and severally with and to the same extent as the seller or buyer, unless such person sustains the burden of proof that he or she did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.[71]

The customers showed that RCG was liable under the Ohio act because it aided Villalba in his illegal sales. The customers also meet the additional Washington requirement that the aid be "material." The courts recognize that a firm "materially aids" a seller's fraud by performing functions such as clearing trades, providing margin accounts and other activities when that firm is aware of illegal activity in the account.

For example, in *Koruga v. Fiserv Correspondent Services, Inc.*,[72] the issue was whether Fiserv, a clearing broker, could be held liable for the fraudulent acts of one of its corresponding brokers. An arbitration panel found that Fiserv was liable under the Washington and California Securities Act provisions making a broker-dealer who materially aids in a transaction

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[71] RCW 21.20.430(3) (quoted in relevant part, plaintiffs do not seek "control person" liability).

[72] *Koruga v. Fiserv Correspondent Services, Inc.*, 183 F. Supp. 2d 1245 (D. Or. 2001), *aff'd*, 40 F. App'x. 364 (9th Cir. 2002).

jointly and severally liable with the seller. The court did not detail the corresponding broker's fraud but concluded that Fiserv knew about the illegal activity and "materially participated" because "it performed necessary functions related to each of the securities transactions with Plaintiffs." [73]

Here, RCG knew of Villalba's illegal activity and performed necessary functions for Villalba's scheme by establishing commodity pool through which Villalba could trade futures – a relationship needed to promote his program that also provided the forum for him to speculate with his clients' money. The court was incorrect in concluding as a matter of law that a jury could not find that RCG either substantially contributed to the illegal sales or materially aided Villalba.

C. Goldberg purchased securities when he invested money with MMA.

The trial court granted summary judgment holding that the customers purchased securities when they made payments to Villalba for the MMA program, except for the purchases made by customer Bernie Goldberg. The trial court held that that Goldberg's payments into the MMA program could not be securities because of a partnership agreement made between Goldberg and Villalba two years before the MMA program began.[74]

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[73] *Koruga*, 183 F. Supp. 2d at 1246.
[74] RP 43-44.

A security exists when a seller touts an "enterprise" that takes investors' money and, through its efforts and expertise, provides a return on that money.[75] Villalba's MMA investment opportunity using his Money Market Plus method was the enterprise that promised financial gain from Villalba's expertise in timing non-leveraged futures transactions.[76] If an investor has the right to exercise "a substantial degree of control <u>over the enterprise into which he has contributed his initial value</u>" then there is no security.[77] In other words, if an investor makes the decisions that determine how the investment will perform, the investor cannot complain about the results:

> [T]he purpose of the Ohio Securities Act is to protect the public from fraudulent investment schemes. This protection is unnecessary when the investor is an active participant in the development and management ***of the enterprise in which he has invested***. In such situations, the investor is not in a position to claim that he was induced to furnish value by means of misstatements or half-truths about the character of the enterprise.[78]

But that was not the case with Goldberg's partnership agreement.

The trial court concluded that Goldberg did not purchase securities when he invested with MMA because the partnership agreement gave him substantial control over the amount of compensation paid to Villalba.[79] That

[75] *State v. George*, 50 Ohio App. 2d 297, 298, 362 N.E.2d 1223, 1225, (1975).
[76] *VASA Order v. RCG Group, L.L.C.*, 2013 Ohio Misc. LEXIS 3, 11-12 (2013).
[77] *George*, 50 Ohio App. 2d at 304 (emphasis added).
[78] *Mazza v. Kozel*, 591 F. Supp. 432, 438 (N.D. Ohio 1984) (emphasis added).
[79] See RP 31.

conclusion didn't address the right issue. The relevant question is whether Goldberg sufficiently controlled the enterprise in which the money was invested (the MMA program) so as to affect the success of that enterprise. "'[T]he mere fact that an investment takes the form of a general partnership or joint venture does not inevitably insulate it from the reach of federal securities laws.' Instead, 'economic reality is to govern over form.'"[80]

The question is one of control: cases finding investments are not securities when made through a partnership "presume that the investor-partner is not in fact dependent on the promoter or manager for the effective exercise of his partnership powers."[81]

While called a partnership, the arrangement between Goldberg and Villalba was similar to the arrangements Villalba had with other customers. Villalba contributed none of his own funds into the partnership. After the MMA account was opened, Goldberg made investments directly to the Money Market Alternative bank account,[82] the same account the other customers made payments to.[83] Villalba's other customers committed to pay

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[80] *Nunez v. Robin*, 415 Fed. Appx. 586, 589 (5th Cir. 2011) *quoting Williamson v. Tucker*, 645 F.2d 404, 422 (5th Cir. 1981). *Accord*, *Casali v. Schultz*, 292 Ark. 602, 605, 732 S.W.2d 836, 837 (1987) ("The mere fact that an investment takes the form of a general partnership does not insulate it from the reach of the Arkansas Securities Act.")

[81] *Williamson v. Tucker*, 645 F.2d 404, 422 (5th Cir. 1981).

[82] CP 2069; CP 2087.

[83] *See*, CP 2036 (¶ 2) and CP 2040-43.

him a percentage of the profits earned from their investments. Goldberg did the same through the partnership agreement. Most significantly, neither Goldberg nor the other customers had any control or influence over the decisions made by Villalba in handling their funds.[84]

Goldberg's reliance on Villalba for the success of his investment further supports the conclusion that his MMA investment was a security:

> A genuine dependence on others might also exist where the partners are forced to rely on some particular non-replaceable expertise on the part of a promoter or manager. Even the most knowledgeable partner may be left with no meaningful option when there is no reasonable replacement for the investment's manager. For example, investors may be induced to enter a real estate partnership on the promise that the partnership's manager has some unique understanding of the real estate market in the area in which the partnership is to invest; the partners may have the legal right to replace the manager, but they could do so only by forfeiting the management ability on which the success of the venture is dependent.[85]

Goldberg could not and did not control Villalba's investment decisions. The fact that Goldberg's direct personal transactions with MMA may be called partnership investments does not preclude a factfinder from concluding that his investments are securities.

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[84] CP 1164. *See, e.g.*, CP 1119.
[85] *Williamson*, 645 F.2d at 423.

D. RCG is liable for negligently supervising its personnel and the MMA account.

1. As confirmed by this Court's decision in *Garrison*, RCG can be liable for losses suffered by customers who do not have individual accounts with RCG but incur losses because of RCG's negligence.

RCG is liable for its negligence in allowing the MMA account to be opened and for its ongoing negligent supervision of that account. RCG argued below that it owed no duty to the customers because they were not its clients. That argument ignored this Court's decision in *Garrison v. SagePoint Fin., Inc.*,[86] which holds that securities firms can be liable to non-customers for negligent supervision.

In *Garrison*, investment advisor Mark Garrison partially owned Acumen Financial Group Inc., a financial advisory firm, and was also an independent contractor investment advisor for AIG Financial Advisors. His grandparents owned trusts worth approximately $26 million. After his grandmother died, and his grandfather was diagnosed with dementia, Garrison became the trustee/manager for his grandparents' trusts and businesses. Wells Fargo held the trusts' investment accounts, which were serviced by the brokers employed by that firm.

Under NASD[87] regulations governing securities firms, Wells Fargo

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[86] *Garrison v. SagePoint Fin., Inc.*, 185 Wn. App. 461, *review denied*, 183 Wn.2d 1009 (2015).

[87] NASD is the acronym for National Association of Securities Dealers, which was

could not accept instructions from an investment advisor employed by another firm without written permission from that firm.[88] AIG agreed to allow Garrison to serve "solely as the trustee/owner/manager" for the trusts' Wells Fargo accounts on the condition that he not act in any other capacity for those accounts and that AIG would be provided account statements and records of transactions in those accounts.

A few months after this permission was received, Garrison told the Wells Fargo stockbrokers that Acumen, the financial firm that he partially owned, would be hired to provide investment advice for the trusts but that Wells Fargo would continue to execute trades in the accounts.[89] After that change, Garrison paid Acumen substantial fees for investment advice, transferred trust funds to personal accounts, and made reckless investments in the Wells Fargo accounts. The trusts lost more than $20 million.

After the losses were discovered, a replacement trustee sued AIG claiming "the monthly statements and trading confirmations AIG received under NASD Rule 3050 revealed suspicious circumstances or 'red flags' triggering the duty to investigate or monitor the transactions in the Wells Fargo brokerage accounts."[90] AIG's failure to do so, the trusts contended,

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authorized by the SEC to regulate securities firms.

[88] NASD R. 3040(c)(1); *Id.* at 475.

[89] *Id.* at 479.

[90] *Id.* at 499

violated NASD rules requiring AIG to properly supervise and monitor accounts making AIG liable to the trust for negligent supervision. This claim was dismissed on summary judgment and appealed.

Garrison initially noted that a brokerage firm generally owes no duty to a non-customer who simply invests money through an independent investment advisor.[91] But it also recognized the "well-defined exception to the general rule" where a duty to a non-customer can arise <u>when the firm discovers troublesome "red flags"</u>:

> 'sufficiently suspicious' circumstances may place a broker-dealer on notice that her customer is perpetrating fraud on non-customer investors. 49 Cal.App.4th [472], 483, 56 Cal.Rptr.2d 756 [(1996)]. Once aware of troublesome 'red flags,' the broker-dealer may have a duty which runs to non-customers to monitor and investigate any unusual account activity.[92]

In *Bear, Stearns & Co. v. Buehler*,[93] a case quoted by *Garrison*, an independent investment advisor opened an account with Bear Stearns for trading funds provided to him by investors and stole approximately $7 million from the account. The investors recovered their losses from Bear Stearns in arbitration.

The Ninth Circuit affirmed the trial court's confirmation of the award:

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[91] *Id.* at 500.

[92] *Id.*; *McGraw v. Wachovia Sec., LLC*, 756 F. Supp. 2d 1053, 1072 (N.D. Iowa 2010) (quoting *Bear, Stearns*, 23 Fed. App'x at 776, other citations omitted).

[93] *Bear, Stearns & Co. v. Buehler*, 432 F. Supp. 2d 1024, 1025 (C.D. Cal. 2000), *aff'd sub nom. Bear, Stearns & Co. v. Buehler*, 23 F. App'x. 773 (9th Cir. 2001).

> Where there is additional involvement by the broker-dealer, a duty may be found. In *Software Design,* the court noted that "sufficiently suspicious" circumstances may place a broker-dealer on notice that her customer is perpetrating fraud on non-customer investors. 49 Cal.App.4th at 483, 56 Cal.Rptr.2d 756. Once aware of troublesome "red flags," the broker-dealer may have a duty which runs to non-customers to monitor and investigate any unusual account activity.[94]

"[N]umerous courts have ruled that broker dealers may be held liable under the common law for negligently supervising their registered representatives, even on dealings with investors who had no accounts with the firm."[95]

The trial court here held that *Garrison* did not apply because the Villalba was not a RCG employee.[96] That distinction is irrelevant. Liability arises because a firm ignores "red flags" suggesting persons are being defrauded that it can do something about. In *Garrison* liability arose when the improperly supervised employee (Garrison) committed fraud not through his employer (AIG), but through a different firm (Acumen), and where the "red flags" appeared in non-customer accounts held by a third firm (Wells Fargo). But a firm (RCG) is also liable in the less-convoluted situation where its improperly supervised employees ignore "red flags" that allow the

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94 *Bear, Stearns & Co. v. Buehler*, 23 F. App'x. 773, 776 (9th Cir. 2001). *See also Javitch v. First Montauk Fin. Corp.*, 279 F. Supp. 2d 931, 939 (N.D. Ohio 2003) (Brokerage firm's customer opened accounts funds diverted from investor s. Court held broker had notice that the funds were supposed to be escrowed, and "implicit in that knowledge is that the duty owed is not merely to the account holder but to the parties whose funds are at issue.")

95 *As You Sow v. AIG Fin. Advisors, Inc.*, 584 F. Supp. 2d 1034, 1049 (M.D. Tenn. 2008).

96 RP 88, 90. The trial court concluded that Villalba's involvement added another "link in the chain" that made *Garrison* inapplicable.

firm's customer (Villalba) to misuse funds from non-customers (MMA customers) in an account handled by the firm (RCG). That is the scenario in *Bear, Stearns* and other cases relied on by *Garrison*.

RCG knew Villalba was trading with other people's money and telling them tales about the investment plan. *Garrison* and its supporting cases hold that with that knowledge, RCG cannot ignore the potential harm to those investors when suspicious activity appears in the MMA account.

2. RCG's negligence was shown through violations of its internal procedures and CFTC and NFA regulations, which establish the minimum standard to assess the scope of RCG's duty.

Garrison holds that rules issued by regulators and a firm's own compliance manuals define the scope of the duty owed by the firm. The court held that the "courts have looked to the [NASD] Rules to define the scope of a common law duty such as negligent supervision.,"[97] further concluding that "as a condition of the right to engage in the securities business, broker-dealers and registered representatives must abide by NASD rules and regulations."[98] And courts give "substantial deference" to a regulator's interpretation of its rules.[99]

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[97] *Garrison* at 486.

[98] *Id. See also, McGraw v. Wachovia Sec., LLC*, 756 F. Supp. 2d 1053, 1075 (N.D. Iowa 2010) (recognizing duty based on NASD Rules); *Piper, Jaffray & Hopwood Inc. v. Ladin*, 399 F. Supp. 292, 299 (S.D. Iowa 1975) (concluding NASD and NYSE rules are "admissible as evidence of negligence"); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 824 (9th Cir. 1980) (NASD and NYSE rules "reflect the standard to which all brokers are held").

[99] *Garrison* at 494.

RCG's negligence began even before trading commenced in the account. As detailed previously, RCG improperly allowed an unregistered commodity pool operator (Villalba) to open an account with funds solicited through a superficial offering circular that misrepresented the risks and realities of futures trading especially with its representations that futures trades would be made with "little or no leverage" and "minimal risk." Because Villalba never became registered and did not have a valid exemption from registration, the trading in the MMA account was illegal. RCG's internal procedures require it to refuse to open an account under those circumstances: "the FCM has the right ***and the duty*** to refuse to accept an account if it suspects that illegal activity is being conducted."[100]

Also, as previously discussed, NFA Bylaw 1101 prohibits its members from doing business with non-members that are required to be registered with the CFTC, including registration as a commodity pool operator.[101] RCG was required to inquire whether Villalba was making the needed filings to claim an exemption and to document that review. The RCG records for the MMA account do not show that Villalba ever attempted to make any filing with the CFTC or NFA.

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[100] CP 1539 (Tanzar Dep. at 80) (emphasis added).

[101] National Futures Association, Bylaw 1101 – Doing Business With Non-Members (quoted in relevant part).

RCG and other FCMs are required to establish procedures for monitoring customer accounts for potential violations of the acts, regulations, and rules.[102] A FCM's failure to follow its own compliance manuals violates Rule 166.3,[103] which requires a FCM to "diligently supervise" the handling of its accounts:

> Each Commission registrant, except an associated person who has no supervisory duties, must diligently supervise the handling by its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) relating to its business as a Commission registrant.[104]

In its investigation into the MMA fraud, the CFTC determined that RCG violated rule 166.3 for several reasons. It noted that the rule is violated (1) when a firm fails to gain sufficient information regarding its customer – noting that RCG failed seek any updated information regarding MMA until shortly before the account closed, (2) when a firm ignores numerous red flags appearing on internal reports or suspicious trading in an account – noting RCG's failure to take action regarding questionable deposits,

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[102] *Samson Refining Co. v. Drexel Burnham Lambert, Inc.*, 1990 CFTC LEXIS 90 at 32, ("[U]nder Rule 166.3, Drexel had a duty to develop procedures for the 'detection and deterrence of possible wrongdoing by its agents.'").

[103] *E.g.*, 2012 CFTC Order ("RCG failed to perform its supervisory duties diligently by not following its compliance procedures that were in place, also in violation of Regulation 166.3, 17 C.F.R. § 166.3").

[104] 17 C.F.R. § 166.3.

disbursements, wire activity, and "the lack of regard for trading losses, commissions, and fees in the MMA account," and (3) failure to make information available to persons supervising an account – noting RCG's failure to provide necessary information regarding MMA to those handling the account.[105]

RCG was also required to monitor the account to assure that the trading was consistent with the investment plan described in the offering circular. RCG failed miserably in this task, assuming that it made an effort to do so. A short glance at a monthly statement would verify that Villalba was not trading only for a "few days a month" as represented to the investors; he was trading almost daily with highly leveraged trades that lost hundreds of thousand dollars (and on occasion a few million dollars) in a single day.[106] RCG recognized its duty to ensure that trading was consistent with the offering circular. It was negligent in not stopping trading and closing the account. Doing so would have saved customers millions of dollars.

E. The trial court incorrectly used the federal Bank Secrecy Act to preclude the customers from receiving evidence (1) specifically exempted from that act, (2) produced to plaintiffs in other litigation involving the MMA account, and (3) described by the CFTC in a public order assessing violations against RCG.

1. Introduction: the protective order.

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[105] CP 1527-28.

[106] CP 1362-1494 (MMA account statements); *see*, CP 1458 ($5.6 million loss on 3/19/08 and $11.47 million loss on 3/20/08).

The customers served discovery on RCG that included requests for information on the opening of the MMA account, what RCG did to monitor the account, and any actions it took with respect to the account. Some of those requests were made after the CFTC publicly issued an order finding that RCG had violated CFTC regulations by failing to properly diligently supervise the MMA account.[107]

While the additional discovery requests were pending, RCG filed a motion for a protective order to prohibit the customers from "conducting discovery relating to RCG's internal investigations and monitoring of suspicious activity" including:

> (1) RCG's inquiries and monitoring of Villalba and the MMA account specifically;
>
> (2) RCG's practices and methods of investigation and monitoring generally; or
>
> (3) The identities of RCG employees charged with suspicious activity monitoring and investigations.[108]

The motion contended that this discovery was prohibited under the federal Bank Secrecy Act,[109] which was written to address the use of American bank accounts to hide and launder money by criminals and foreign terrorists. The Act requires that banks report certain types of

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[107] 2012 CFTC Order, CP 1522-32.
[108] CP 23-37.
[109] 31 U.S.C. § 5318(g).

suspicious activity to the federal government in a suspicious activity report (SAR).[110] The act affords a privilege to the federal government, allowing it to keep these reports confidential, and prohibits disclosure of the SARs or information that an SAR was filed by others.

RCG asserted that it was prohibited by the BSA from producing the information requested by the customers in this case even though most, if not all, of the information sought had been provided to plaintiffs' counsel in the two Ohio cases filed against RCG regarding the MMA account. This included depositions taken in those cases where former RCG employees readily testified regarding RCG's investigation of MMA and its policies and practices for detecting fraud, money laundering or other criminal activity by its customers.[111] Nonetheless, the requested order was granted.[112]

As a result of this order, RCG kept relevant information from the customers, including testimony from other cases regarding how RCG dealt with suspicious circumstances when opening new accounts.[113]

The customers sought reconsideration of this order. The trial court, however, only modified the order to the extent that the order would not

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[110] 31 U.S.C. § 5318(g)(1); 12 C.F.R. § 21.11.
[111] CP 27-28 (footnote 5). *See*, CP 2218-2367.
[112] CP 1221-22.
[113] CP 2249. The testimony within the borders was redacted by RCG. CP 2218-2367 contains a declaration and exhibits showing the scope of information withheld by RCG and how some of that information was contained in the public the 2012 CFTC order.

apply to "materials which are already publically available from prior litigation on the MMA account against RCG."[114]

Issues addressing the interpretation of the privilege provided by the BSA are reviewed *de novo* by this court.[115] The protective order should be vacated. **First**, the BSA confidentiality requirement applies only to the actual SARs and information revealing the existence of a SAR and expressly does not include "the underlying facts, transactions, and documents upon which a SAR is based." The protective order does not draw that distinction; it prohibits discovery regarding all documents regarding monitoring and inquiries of the MMA account. **Second**, under the specific regulations applicable to FCMs, reports of suspicious activity in connection with violations of CFTC and NFA regulations are not subject to the BSA confidentiality requirements. Those exclusions are also ignored by the protective order. **Third**, RCG recognizes that none of the information it produced in the two cases in Ohio is subject to the BSA. It did not seek protection in either of those courts for those materials and did not follow the statutory requirements for asserting a BSA privilege claim.

2. Even if a protected SAR had been filed, the requested materials should still be produced.

[114] CP 2373-75.

[115] *Norton v. U.S. Bank, NA*, 179 Wn. App. 450, 454 (2014) (reviewing protective order under Bank Secrecy Act).

The discovery requested included reports, communications regarding the MMA account, data gathered on the account, and similar materials. Even if RCG had filed a protected SAR, those materials are still discoverable. The BSA's confidentiality provision expressly excludes "the underlying facts, transactions, and documents upon which a SAR is based." 31 C.F.R. § 1026.320(e)(1)(ii)(A)(2). The protective order ignores that exclusion: it prohibits discovery into "inquiries and monitoring of Villalba and the MMA account" with no exception.

The order also prohibits discovery of "RCG's practices and methods of investigation and monitoring generally" and the "identities of RCG employees charged with suspicious activity monitoring and investigations." The regulations do not include these restrictions. Nor did RCG demonstrate that by providing that information it would disclose the existence of a protected SAR for the MMA account. The discovery prohibitions in the protective order cannot be justified by the BSA and its regulations.

3. The protective order failed to consider the specific regulations applicable to RCG.

The BSA originally applied only to national banks but was later extended to include other institutions, including brokerage firms. A separate set of regulations was created for each institution subject to the act. National banks are regulated under C.F.R. Part 1020 and FCMs under C.F.R. Part

1026. This is significant because the reporting requirements and exemptions are different for FCMs than for national banks.

FCMs are restricted from disclosing "a SAR or any information that would reveal the existence of a SAR." 31 C.F.R. § 1026.320(e)(1)(i). However, this confidentiality provision applies only to suspicious activity reports ***prepared for filing with FinCEN***:

> For purposes of this paragraph (e) only, a SAR shall include any suspicious activity report ***filed with FinCEN*** pursuant to any regulation in this chapter.[116]

The confidentiality restriction does not apply to reports of suspicious activity submitted to the CFTC or NFA.

An FCM is not required to file an SAR with FinCEN regarding violations that are reportable under the CEA, CFTC regulations, the rules of any registered futures association, or a registered entity.[117] Thus, suspicious activity observed in monitoring and reviewing accounts for compliance with CFTC regulations and NFA rules does not require a SAR filing with FinCEN. The regulations governing national banks do not have a similar exclusion.

FCMs are required to monitor their accounts for "suspicious activity" for reasons other than preparing SARs for filing with FinCEN. Villalba's

[116] 31 C.F.R. § 1026.320(e) (emphasis added). FinCEN is the federal Financial Crimes Enforcement Network.
[117] 31 C.F.R. § 1026.320(c)(1)(ii).

use of a RCG account to defraud plaintiffs through risky and disastrous trades in futures contracts exemplifies why the CFTC (for commodities trading) and the SEC (for securities transactions) require securities brokers and FCMs to monitor and report on their clients' accounts. The account reviews and investigations required by those regulations are for the protection of investors, not just to detect and report possible money laundering or terrorist activity to FinCEN. That is why investigations and account reviews of securities and commodities accounts do not implicate the filing of a SAR protected by the Bank Secrecy Act.

For example, CFTC Rule 166.3 requires an FCM to "diligently supervise" the handling of commodities accounts. In order to comply with that rule RCG and other FCMs are required to establish procedures for monitoring customer accounts for potential violations of the acts, regulations, and rules.[118] Information and reports gathered to meet these requirements is not required to be reported in an SAR to FinCEN and, thus, is not subject to the BSA confidentiality restrictions.

RCG argued to the trial court that <u>any</u> monitoring or investigation of the MMA account, which would include the monitoring required by CFTC rule

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[118] *Lobb v. J. T. McKerr & Co.*, 1990 CFTC LEXIS 90, 32, Comm. Fut. L. Rep. (CCH) ¶24,596 ("[U]nder Rule 166.3, Drexel had a duty to develop procedures for the 'detection and deterrence of possible wrongdoing by its agents.'").

166.3, necessarily implicates the filing of an SAR. It does not. That is why the CFTC, which is subject to the same confidentiality restrictions regarding SARs as RCG,[119] could publicly in its Order: (a) describe how Villalba's account should have been monitored under RCG's compliance manuals; and (b) detail the numerous "red flags" in the MMA account that RCG should have discovered and acted upon – all of which involved violations of CFTC regulations.

RCG claims its overbroad protective order is justified by this court's decision in *Norton v. U.S. Bank N.A.*[120] *Norton* involved a former employee of a bank who moved to Peru to operate an investment firm. He maintained several accounts at the bank, which were allegedly used to circulate and hide investor money between the United States and Peru. The funds disappeared and his investors sued the bank, claiming it owed them a fiduciary duty to protect the funds they deposited. The bank sought a protective order to prohibit investors from obtaining copies of internal investigations and procedures.

The *Norton* court apparently concluded that information disclosing that an investigation occurred would reveal the existence of a protected SAR. The *Norton* court relied heavily on *Union Bank of California v. Superior*

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[119] *See*, 31 C.F.R. § 1026.320(e)(2)).
[120] *Norton*, 179 Wn. App. 450.

Court,[121] which blocked production of a document called "Form 244" that the bank used to compile "suspicious activity" to prepare an SAR.[122] However, "the ***sole purpose*** of the Form 244 is to aid the bank in complying with its obligation under federal law to report suspicious activity and file SAR's."[123] Thus, the mere existence of a completed Form 244 evidenced the filing of a protected SAR. From that, *Norton* concluded that "requiring U. S. Bank to disclose information about internal investigations or monitoring of the Nino de Guzman accounts in particular, or internal methods of tracking unusual patterns and banking activity in general, would reveal the existence of a Suspicious Activity Report and undermine public policy."[124] That holding is inapplicable when, as here, monitoring and investigation of an account do not necessarily implicate the filing of a protected SAR because suspicious activity that is reported to comply with CFTC and NFA regulations does not have to be submitted in a protected SAR.

Thus, the protective order improperly prohibited discovery of investigations and monitoring of the MMA account conducted to comply with CFTC and NFA regulations, which was relevant to both the customers'

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[121] *Union Bank of California v. Superior Court*, 130 Cal. App. 4th 378, 386, 29 Cal. Rptr. 3d 894 (2005).

[122] *Norton* at 460.

[123] *Union Bank*, 29 Cal. Rptr. 3d at 898 (emphasis added).

[124] *Norton* at 460.

securities and negligent supervision claims.

4. RCG recognized that the requested information was not subject to the Bankruptcy Secrecy Act by producing the information in other litigation without seeking approval to do so as required by the Act.

RCG recognized that the information requested by the customers was not confidential under the BSA. Had the requests sought "a SAR or any information that would reveal the existence of a SAR," RCG was required to "notify FinCEN of any such request and the response thereto."[125] RCG refuses to say whether this was done.[126] The fact that RCG produced the supposedly confidential materials in other litigation, however, shows that it either did not provide the required notice or FinCEN did not object to the production. The protective order was not obtained out of respect for the BSA; it was simply a discovery tactic to conceal relevant evidence.

The protective order issued by the trial court should be vacated.

V. CONCLUSION

This Court should reverse the summary judgment dismissing the customers' securities and negligence claims, reverse the trial court's ruling that customer Goldberg's investments with MMA were not securities, and vacate the protective order issued by the trial court that prohibited discovery into RCG's role in monitoring and reviewing the MMA account.

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[125] 31 C.F.R. § 1026.320(e)(1)(i).
[126] CP 1205-06 (¶ 13).

DATED: October 23, 2015.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify, under penalty of perjury and in accordance with the laws of the State of Washington, that on October 23, 2015, I caused a copy of the foregoing document to be served on all counsel of record as indicated below:

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DATED: October 23, 2015, at Seattle, Washington.

Chris R. Youtz (WSBA #7786)

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APPENDICES

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IN THE COMMON PLEAS COURT OF ERIE COUNTY, OHIO

ARTHUR J. PIERETTI, et al.,	:	Case No. 2011-CV-0051
Plaintiffs	:	Judge Tygh M. Tone
Vs.	:	**OPINION AND JUDGMENT ENTRY**
ROSENTHAL COLLINS GROUP, LLC et al.	:	
Defendants	:	

****

This matter comes before the Court on Defendant's, Rosenthal Collins Group L.L.C.'s Supplemental Motion for Summary Judgment. After a thorough review of the pleadings said motion is **GRANTED** in part and **DENIED** in part.

FACTS

Enrique Villalba Jr., a non-party to this lawsuit, was an investment advisor who claimed to have developed a proprietary method of investing known as the Money Market Plus Method. Mr. Villalba solicited Plaintiffs as prospective investors via oral and written representations and utilized momentum filters to predict the momentum of the equity markets. The funds were to be invested in either treasury bills or interest bearing money market accounts.

Plaintiffs invested over 13 million dollars in the fund held in the name of Money Market Alternative, LP, (hereinafter MMA), the entity owned by Villalba. By May 2009 the funds were gone.

Mr. Villalba provided his clients with account statements showing the performance of the client's investment in the MMA. The quarterly statements generally reflected that Plaintiffs' investment had earned profits. Therefore the clients invested more money in the Fund.

The Defendant Rosenthal Collins Group L.L.C. (hereinafter known as the Defendant/RCG) reaped high commissions from the trading in the Money Market Alternative LP account. Patrick McDonnell was appointed as its authorized agent.

ARGUMENTS

Defendant's Argument

Whether RCG Aided or Participated in the Sale of Securities

RCG argues that it did not participate in or aid Villalba in any way in making the sale of a security. R.C. 1707.43(A) limits liability by the secondary actor to an act in furtherance of the sale of a security. Secondary liability is limited to aspects of the scheme dealing with the unlawful sale. Ohio courts are clear that for secondary liability the secondary actor must provide more than operational assistance to the seller; instead the secondary actor must be directly participating in the sale. RCG argues that there is no evidence that RCG played a role in the process where Villalba solicited or sold the securities. At most, RCG provided administrative or operation services necessary for MMA to trade commodities. However, such conduct was separate and removed from the actual making of the sale. There is no evidence that RCG met with the Plaintiffs, created or sent out offering materials, sale literature or statements used in the sale process.

Instead, RCG's role involved actions after the sale. After Villalba received money from the Plaintiffs in his MMA bank accounts, Villalba wired at least some of the money to a nondiscretionary, future trading account held in the name of MMA at RCG. Plaintiffs did not receive documents from RCG; never spoke with any at RCG. Instead, MMA's relationship with RCG was limited to providing professional services related to MMA's commodity trading. There can be no liability pursuant to R.C. 1707.43(A) for opening futures account and executing and clearing future trades.

Plaintiffs' Negligence Claim

RCG argues that since Plaintiffs were not customers of RCG, RCG did not owe Plaintiffs any duty to detect and prevent Villalba's fraud. Further, even if Plaintiffs were considered customers of RCG, the only duty RCG has to non-discretionary customers is to effectively carry out customer's trades. RCG did not owe a duty to Plaintiffs to monitor Villalba's trading to ensure that he was complying with his promises to Plaintiffs. Thus, even if RCG owed Plaintiffs a duty, such duty was not breached.

Plaintiffs' Argument

Whether RCG Aided or Participated in the Sale of Securities

Plaintiffs argue that Ohio's Securities Act is drafted broadly and should be construed broadly. In fact, Ohio's Blue Sky laws are the broadest in the nation. In the Uniform Securities Act, Section 410(b) requires the employee, agent, or broker to materially aid in the sale. However, R.C. 1707.43 does not include "materially." Whether RCG materially aided would be a fact issue, thus whether RCG's conduct provided mere aid is certainly a fact issue. Further, any kind of aid will do in Ohio; this negates RCG's argument that providing only administrative or operational services is insufficient. Further, RCG's argument is irrelevant as R.C. 1707.43 does not require materiality.

Also, Plaintiffs argue that there is little caselaw interpreting the relevant statutory language and the precise limits of liability. According to Plaintiffs, the cases cited by RCG do not provide universal limits. Plaintiffs assert that the secondary actor does not need to induce a purchaser; instead the secondary actor only needs to participate in the sale or aid the seller in any way.

Further, Plaintiffs argue that RCG's premise that Plaintiffs' claims are based upon post sale conduct is "wildly off target." Also, participate and aiding are two different concepts. Participate addresses the sale activities causing the sale; aiding involves the activities which do not directly lead to a sale but make the sale possible. Because RCG opened, maintained and serviced a futures trading account for MMA, RCG's activities were a substantial factor in bringing about the securities sales to Plaintiffs. According to RCG's Compliance Manual, RCG had a Know Your Customer Rule "KYC." Pursuant to the KYC rule, during the account opening process RCG must learn of the customer's investment objectives and source of income and assets. When MMA's account was opened in 1998, RCG received MMA's circular. The Circular stated that it had commenced a $100 million "securities" offering the day following MMA's legal formation in February 1998. Yet as of May 1998 the only security sold was to MMA's General Partner in exchange for $300,000. Plaintiffs argue that it was apparent to RCG that MMA was using the RCG proposed account as a commodities pool that the Circular intended to raise money so that MMA could function like a mutual fund. RCG's director of compliance read the circular and passed the circular on to RCG's in-house counsel.

The circular was fraudulent on its face for several reasons and thus RCG knowingly undertook a role in the continued fraudulent offering of securities. Further, the actual trading in the account materially deviated from the trading strategy represented in the circular. Further, RCG had warning signs such as MMA invested more than its net worth. Plaintiffs argue that the sales could not have happened unless MMA had a futures commission merchant, which RCG agreed to be, so that the opportunity could be better than a money market fund.

Plaintiffs' Negligence Claim

Plaintiffs argue that this Court has already rejected the line of cases cited by RCG in a previous opinion and held that the negligence duty is owed to parties whose funds are at issue. Further, as explained above, RCG knew that at least $120,000 in excess of MMA's net worth was deposited by the end of 2003. RCG admitted that such money must have been some else's money. Further, Plaintiffs argue that money originating with the Plaintiffs went into the MMA account at RCG during 2007-2009.

ANALYSIS

Ohio Rules of Civil Procedure 56(C) authorizes a court to grant summary judgment when the moving party has demonstrated "(1) that there is no genuine issue as to any material fact; (2) that the moving party is entitled to judgment as a matter of law; and (3) that reasonable minds can come to but one conclusion, and that conclusion is adverse to the party against whom the motion for summary judgment is made, who is entitled to have the evidence construed most strongly in his favor." *Harless v. Willis Day Warehousing Co.*, 54 Ohio St.2d 64, 66-67, 375 N.E.2d 46 (1978); Civ.R. 56(C). Once the moving party has satisfied its initial burden, the nonmoving party bears a reciprocal burden under Civ.R. 56 (E):

> When a motion for summary judgment is made *and supported as provided in this rule*, an adverse party may not rest upon the mere allegations or denials of his pleadings, but his response, by affidavit or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, summary judgment, if appropriate, shall be entered against him. *Dresher v. Burt*, 75 Ohio St.3d 280, 293, 662 N.E.2d 264 (1996).

<u>Whether Defendant Participated or Aided Villalba in Any Way in Making A Sale of Securities to Plaintiffs</u>

The Ohio Securities Act, otherwise called Ohio Blue Sky Law, was adopted on July 22, 1929 "to prevent the fraudulent exploitation of the investing public through the sale of securities." *In re Columbus Skyline Securities, Inc.*, 74 Ohio St.3d 495, 498, 660 N.E.2d 427 (1996). Further, "many of the enacted statutes are remedial in nature, and have been drafted broadly to protect the investing public from its own imprudence as well as the chicanery of unscrupulous securities dealers...in order to further the intended purpose of the Act, its securities anti-fraud provisions must be liberally construed." *Id.*

As set forth in R.C. 1707.43(A):

> Subject to divisions (B) and (C) of this section, every sale or contract for sale made in violation of Chapter 1707. of the Revised Code, is voidable at the election of the purchaser. The person making such sale or contract for sale, *and every person that has participated in or aided the seller in any way in making such sale or contract for sale*, are jointly and severally liable to the purchaser, in an action at law in any court of competent jurisdiction, upon tender to the seller in person or in open court of the securities sold or of the contract made, for the full amount paid by the purchaser and for all taxable court costs, unless the court determines that the violation did not materially affect the protection contemplated by the violated provision. (emphasis added).

As Plaintiffs state, unlike the Uniform Securities Act which requires "materiality," pursuant to R.C. 1707.43 any kind of aid will do. Liability is not dependent upon whether Defendants helped induced the purchaser to invest. Further, Plaintiffs correctly argue that the present matter is distinguishable from many of the cases cited by RCG applying R.C. 1707.43. While the court in *Strunk* found no liability due to a lack of evidence of the appellees' participating in the sale of stock to the appellant, appellees were a corporate parent and a shareholder in which the parent sold its subsidiary and thereafter the subsidiary sold alleged securities without the parent's involvement. *Strunk v. Settles*, 1st Dist. No. 827, 1980 Ohio App. LEXIS 11813. Lastly, in *Hild*, cited by RCG, the actions by a lender's in house attorney were at issue for liability pursuant to R.C. 1707.43, not the actions of the lender. *Hild v. Woodcrest Asso.*, 59 Ohio Misc. 13, 30, 391 N.E.2d 1047 (C.P. 1977). Thus, the caselaw cited by RCG fails to provide this Court with a precise limit of liability for secondary actors.

In making all inferences in favor of the nonmoving party, Plaintiffs have presented sufficient evidence of RCG's participation and aid in the sale of the securities in order to survive a motion for summary judgment. Villalba may not have been able to sell the securities to Plaintiffs unless RCG agreed to be MMA's future commission merchant. RCG opened, maintained, and serviced the futures trading account for MMA. Such activities by RCG may have made the sale of the securities possible. Further, RCG conducted two separate high-level reviews of MMA's Circular when it opened a futures trading account for MMA in 1998. The Circular stated that MMA commenced a $100 million "securities" offering in February 1998, MMA was extending the offering for as long as five years, and MMA was reserving the right to extend or reopen the offering at any time. Further, in construing the evidence most strongly in Plaintiffs' favor, a jury could reasonably conclude that the Circular contained several material misrepresentations that RCG should have detected during its review of the Circular such as:

(1) The Circular stated that "[t]he fund is not governed or regulated by any federal or state agency." However, the offering was in fact subject to anti-fraud statutes and licensing requirements.
(2) The Circular stated that MMA would purchase "S & P 500 Index futures contracts with little or no leverage." However, future contracts typically have the leverage of 10:1.
(3) The Circular stated "[a]pproximately 90% of the year, the asset value of the portfolio will not fluctuate on a daily basis as the dollars in the portfolio will remain in non-fluctuating Treasury Bills or short term commercial paper." However, treasurer bills fluctuate in value with interest rates.
(4) The Circular stated that "underlying asset risk is minimal." However, RCG's own Risk Disclosure Statement states that "[t]transactions in futures carry a high degree of risk."

Thus, in making all reasonable inferences in favor of the nonmoving party, based upon the foregoing a jury could reasonably conclude that RCG knowingly undertook an indispensable role in the fraudulent offering of securities that was to extend well into the future.

Whether RCG Owed a Duty of Care to Plaintiffs

"In order to recover on a negligence claim, a plaintiff must prove (1) that the defendant owed the plaintiff a duty, (2) that the defendant breached that duty, and (3) that the breach of the duty proximately caused the plaintiff's injury." *Chambers v. St. Mary's Sch.*, 82 Ohio St.3d 563, 565, 697 N.E.2d 198 (1998). In the October 26, 2011 Opinion and Judgment Entry this Court, citing *Javitch v. First Montauk Financial Corp.*, 279 F.Supp.2d 931 (N.D.Ohio 2003), rejected RCG's arguments and held that "there is a duty owed not merely to an account holder but also to the parties whose funds are at issue...there is an independent common law tort duty that exists and that Plaintiffs can prove facts that would entitle them to relief."

However, at this stage it has become apparent that Plaintiffs cannot prove facts entitling them to relief. RCG correctly distinguishes *Javitch*, in which the broker knew that the funds in the account were escrowed. Unlike escrow accounts in which the funds are held from a party pending the completion of a transaction and the escrow agent owes a fiduciary duty to both parties to hold such funds pursuant to the parties' instruction, the Plaintiffs in the present manner were expecting that the funds in the MMA account at RCG would be traded by Villalba. *See Vasa Order of America, et al. v. Rosenthal Collins Group, L.L.C., et al.*, C.P. No. 2011 CV 753705 (Jan. 29, 2013) (distinguishes *Javitch* as the case at bar did not involve an escrow account, brokerage accounts where not opened in the clients' names, and a direct customer relationship between the broker and the defrauded investors did not exist). In the present manner, Plaintiffs have not set forth specific facts showing that there is a genuine issue of material fact in regards to whether the MMA account at RCG was an escrow account or similar to an escrow account, RCG's knowledge thereof in order to trigger a duty to non-customers whose funds are at issue, and any direct relationship between RCG and Plaintiffs. As stated in *Vasa Order of America*, a fiduciary relationship may be created out of an informal relationship only when both parties understand that a special trust or confidence has been reposed. *Id.* at ¶26. Thus, a fiduciary relationship cannot be unilateral, it must be mutual. Therefore, this Court holds that even in construing the evidence in a light most favorable to the Plaintiffs, reasonable minds can only come to the conclusion that RCG did not have a duty of care to Plaintiffs, non-customers whom RCG had no direct relationship with. Therefore, Plaintiffs' negligence claim fails as a matter of law.

JUDGMENT ENTRY

It is therefore **ORDERED, ADJUDGED AND DECREED** that Defendant's, Rosenthal Collins Group L.L.C.'s Supplemental Motion for Summary Judgment is **GRANTED** in part and **DENIED** in part. It is **ORDERED** that Defendant RCG did not owe Plaintiffs a duty of care and thus is not liable as a matter of law for Plaintiffs' negligence claim. The remainder of RCG's said motion is **DENIED.**

IT IS SO ORDERED.

4/16/13
Date

Judge Tygh M. Tone

cc: D. Meyer
J. Landskroner
C. Kemnitz
M. Conti
J. Murray

Vasa Order v. Rosenthal Collins Group, L.L.C.

State of Ohio, Court of Common Pleas, Cuyahoga County

January 29, 2013, Decided

CASE NO. CV 11 753705

Reporter
2013 Ohio Misc. LEXIS 3

VASA ORDER OF AMERICA, et al., Plaintiffs, vs. ROSENTHAL COLLINS GROUP, L.L.C., et al., Defendants.

Case Summary

Overview

A self-styled investment advisor (IA) deposited clients' money into a brokerage account with defendants. Defendants apparently ignored "red flags" as to the IA's actions. The IA was eventually convicted of wire fraud. The clients filed multiple claims against defendants. In resolving defendants' dismissal motion, the court found that a claim under *R.C. 1707.43* that defendants were liable for aiding and abetting the IA's securities fraud survived challenge, as the IA was involved in the sale of "investment contracts," which were securities under *R.C. 1707.01(B)*.

Outcome

Motion denied as noted.

LexisNexis® Headnotes

Constitutional Law > Supremacy Clause > Federal Preemption

HN1 It is well-established that three types of federal preemption exist, one express and two implied. Express preemption exists when Congress expresses a clear intent to preempt state law in the language of the statute. The first type of implied preemption, field preemption, is implicit where Congress indicates an intent to occupy exclusively an entire field of regulation; that intent is inferred, for example, from a federal regulatory scheme that is so pervasive as to make reasonable the inference that it left no room for the states to supplement it. The second type of implied preemption, conflict preemption, occurs either where it is impossible to comply with both federal and state law, or where state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress as reflected in the language, structure and underlying goals of the federal statute at issue.

Constitutional Law > Supremacy Clause > Federal Preemption

Business & Corporate Compliance > ... > Governments > Agriculture & Food > Commodity Exchange Act

Securities Law > Commodities Futures Trading > Federal Preemption

HN2 The Commodity Exchange Act (CEA) is found at *7 U.S.C.S. §§ 1-27f*. *7 U.S.C.S. § 2(a)(1)(A)* confers jurisdiction on the Commodities Futures Trading Commission with respect to accounts, agreements, and transactions involving swaps or contracts of sale of a commodity for future delivery traded or executed on a contract market designated pursuant to *7 U.S.C.S. § 7* or a swap execution facility. But that section also provides that nothing contained in this section shall supersede or limit the jurisdiction conferred on courts of the United States or any state. This suggests that Congress intended to comprehensively regulate activities directly related to commodity markets but left conduct of the participants in those markets not directly connected to a transaction open to additional federal or state regulation, including common law remedies. The CEA then is not a regulatory scheme that is so pervasive as to make reasonable the inference that it left no room for the states to supplement it. Federal trial courts have concurred. Although the legislation is comprehensive, the legislative history of the CEA and its amendments clearly evinces an intent to preempt state regulation of commodities markets but not to preempt all state common law remedies.

Securities Law > Blue Sky Laws > Civil Liability > General Overview

Securities Law > Blue Sky Laws > Types of Securities

HN3 *R.C. 1707.43* provides that every person that has participated in or aided the seller in any way in making a sale in violation of *R.C. Chapter 1707* is "jointly and severally liable to the purchaser" for the return of the purchase price of the security or contract at issue. *R.C. 1707.01(B)* defines securities that are covered by Chapter 1707 to include "any investment contract." There is an "investment contract" when: (1) an offeree furnishes initial value to an offeror; and (2) a portion of this initial value is subjected to the risks of the enterprise; and (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise; and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

Securities Law > Blue Sky Laws > Types of Securities

HN4 For purposes of determining if an investment contract under R.C. Chapter 1707 exists, the "enterprise" of an investment manager is to invest clients' money with the expectation of receiving a return on that capital. An inevitable feature of such an enterprise is that the funds are subjected to its risks. There is nothing about the definition of an investment contract that requires the funds of more than one person to be pooled to satisfy this part of the test. As long as the money invested is subject to the risks of the enterprise, the presence of one investor is enough.

Securities Law > Blue Sky Laws > Types of Securities

HN5 The last part of the test for purposes of determining if an investment contract under R.C. Chapter 1707 exists can be satisfied only if the plaintiffs did not have the right to exercise practical and actual control over the managerial decisions of the enterprise. This part of the test exists because the absence of direct control over the investment by the investor is traditionally an essential feature of a "security." The fourth prong does not require an examination of whether the investor actually managed or controlled the investment, but whether it had the right to do so.

Securities Law > Blue Sky Laws > Civil Liability > General Overview

HN6 R.C. 1707.43 does not require that a person induce a purchaser to invest in order to be held liable. Rather, the language is very broad, and participating in the sale or aiding the seller in any way is sufficient to form a basis for liability under R.C. 1707.43.

Securities Law > Blue Sky Laws > Civil Liability > General Overview

Torts > ... > Multiple Defendants > Concerted Action > Civil Aiding & Abetting

HN7 There is uncertainty about whether a cause of action for aiding and abetting a defendant's tortious conduct is viable in Ohio. However, if it does exist it certainly requires more culpability than a R.C. 1707.43 claim.

Evidence > Burdens of Proof > Allocation

Torts > ... > Concerted Action > Civil Conspiracy > Elements

HN8 In order to establish the tort of civil conspiracy, a plaintiff must prove the following elements: (1) a malicious combination of two or more persons; (2) causing injury to another person or property; and (3) the existence of an unlawful act independent from the conspiracy itself.

Business & Corporate Law > Agency Relationships > Fiduciaries > General Overview

Business & Corporate Law > ... > Causes of Action & Remedies > Breach of Fiduciary Duty > Elements

Torts > Intentional Torts > Breach of Fiduciary Duty > Elements

HN9 The three elements of a breach of fiduciary duty claim are the existence of a duty arising from a fiduciary relationship, a failure to observe the duty, and an injury resulting proximately therefrom. A fiduciary relationship is one in which special confidence and trust is reposed in the integrity and fidelity of another and there is a resulting position of superiority or influence, acquired by virtue of this special trust. A fiduciary relationship may be created out of an informal relationship only when both parties understand that a special trust or confidence has been reposed. Thus, a fiduciary relationship cannot be unilateral; it must be mutual.

Contracts Law > Remedies > Equitable Relief > Quantum Meruit

HN10 The elements of unjust enrichment include: 1) a benefit conferred by a plaintiff upon a defendant; 2) knowledge by the defendant of the benefit; and 3) retention of the benefit by the defendant under circumstances where it would be unjust to do so without payment.

Torts > Intentional Torts > Conversion > Elements

HN11 Conversion is a wrongful exercise of dominion over property in exclusion of the right of the owner, or withholding it from his possession under a claim inconsistent with his rights. The elements for conversion are plaintiffs' ownership or interest in the property; plaintiffs' actual or constructive possession or immediate right to possession of the property; defendant's wrongful interference with plaintiffs' property rights; and damages.

Evidence > Burdens of Proof > Allocation

Torts > Intentional Torts > Conversion > Elements

HN12 Ordinarily a claim for conversion involves an identifiable piece of property, not cash. To maintain a conversion claim involving currency, a party must demonstrate that the money was: (1) delivered for safekeeping; (2) intended to be segregated; (3) remained in substantially the form in which it was received; and (4) not subject to a title claim by the keeper.

Counsel: [*1] Joel Levin, Esq., Aparesh Paul, Esq., Bruce B. Elfvin, Esq., Attorneys for plaintiffs.

John T. Murray, Esq., Patrick G. O'Connor, Esq., Attorneys for defendant Rosenthal Collins.

Judges: JUDGE JOHN P. O'DONNELL.

Opinion by: JOHN P. O'DONNELL

Opinion

JOURNAL ENTRY

John P. O'Donnell, J.:

STATEMENT OF THE CASE

This lawsuit was filed on April 21, 2011. A first amended complaint was then filed on August 5. Defendant Rosenthal Collins Group, LLC moved on August 26 to dismiss the first amended complaint. That motion was opposed by the plaintiffs on September 30, and the movant filed a reply brief on November 4. [1] Finally, by a filing on December 1, 2011, the plaintiffs notified the court of an October 26, 2011, opinion and judgment entry on a similar motion in the case of *Arthur J.* Pieretti v. Rosenthal Collins Group, L.L.C., et al., Erie County Court of Common Pleas case number 2011 CV 0051. This entry follows.

STATEMENT OF FACTS[2]

Plaintiff Rolf Bergman is the grand master of plaintiff VASA Order of America, a Swedish fraternal membership organization. Plaintiff VASA Order of America National Archives, Inc. gathers and preserves historical documents related to Swedish immigration to America. Both of the corporate plaintiffs are non-profit entities.

Enrique F. Villalba was a self-styled investment manager who never had a license to sell securities in Ohio. Villalba solicited clients by promising a superior return on their investments for nearly no risk. Beginning in 2007, the three plaintiffs separately began investing money with Villalba. Each plaintiff entered into a similar investment management agreement.

The agreements described Villalba as "the investment manager." By the contracts, each plaintiff deposited money with Villalba and gave him "full authority" to make "day-to-day investment decisions" for the plaintiffs. In particular, Villalba was given the authority to "invest and reinvest the assets in the account and . . . to make determinations as to which securities are [*3] to be bought or sold, where the securities are to be bought or sold for the account, without obtaining the consent of, or consulting with the client." The contract authorized Villalba to "select brokers or dealers to execute orders for the purchase or sale of securities," but did allow the plaintiffs to direct "brokerage transactions" to a specific broker. For his services, Villalba would be compensated with 12% or 15% of profits, depending upon the amount of assets under management.

To distinguish himself from other investment advisers, Villalba promoted what he called the money market plus method. When the plaintiffs gave their money to Villalba, he deposited it into a brokerage account opened in the name of Money Market Alternative, L.P.

The brokerage where that account was established is defendant Rosenthal Collins Group, L.L.C. Rosenthal Collins is a registered futures commission merchant with the Commodity Futures Trading Commission but is not registered to offer or sell securities in Ohio. Rosenthal Collins earned commissions on the plaintiffs' money by acting as the clearing broker between Money Market Alternative, L.P., as buyer, and the sellers of commodity futures. Defendant [*4] Patrick D. McDonnell is Rosenthal Collins's agent who was charged with overseeing Money Market Alternative, L.P.'s account. Defendant McDonnell Futures, Inc. is a company owned by defendant McDonnell and both McDonnell and McDonnell Futures earned commissions by clearing trades made with the plaintiffs' money.

Villalba began promoting his money market plus method around 1996. However, instead of the high return/low risk

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[1] A reply brief was filed on November 3 that is identical to the reply filed November 4 except that it omitted Exhibit A to the reply brief: copies of two of the plaintiffs' investment management agreements.

[2] The court's statement of facts consists of direct quotations from the first amended complaint, [*2] reasonable paraphrases of the first amended complaint, and, where noted, references to the plaintiffs' investment management agreements.

investments he claimed he would make. Villalba commingled the plaintiffs' money with money from his other clients and used it to fund the Money Market Alternative account at Rosenthal Collins. He then used that account to buy and sell "speculative commodity futures contracts, including contracts for the S&P Index, Treasuries, and gold." Villalba produced regular account statements purporting to show his investors their gains and losses, but these statements were false. The false appearance of profit induced investors, including the plaintiffs, to put more money under Villalba's management.

The Money Market Alternative, L.P., account at Rosenthal Collins was opened around June, 1998, and remained there until 2009. Rosenthal Collins knew since 1998 that Villalba "was not [*5] registered as an investment adviser and that he was not authorized in any way to sell securities under any state or federal law." The defendants also "had full knowledge that Villalba was operating an illegal and unregistered commodities pool" that was not registered as required with the CFTC. Additionally, the defendants knew that Villalba was "unlawfully soliciting and commingling investor money, promoting and selling unlicensed securities . . . and speculatively trading in the firm's customer account in grossly leveraged positions." The defendants ignored "red flags" that Villalba was "violating a host of industry regulations and state securities laws."

Eventually, in 2009, Villalba disassociated himself from Rosenthal Collins and tried to open an account with another broker. That broker recognized the likelihood that Villalba was acting illegally and declined to open an account. A short time later, Villalba was indicted and eventually pled guilty to wire fraud. He is now incarcerated in a federal prison.

THE PLAINTIFFS' CAUSES OF ACTION

Based on those facts, the plaintiffs assert seven causes of action against the defendants. First, the plaintiffs claim that the defendants are liable [*6] under *section 1707.43 of the Ohio Revised Code* for aiding and participating in Villalba's securities law violations. Count two is a common law claim for aiding and abetting Villalba's fraud. Count three is for civil conspiracy, *i.e.*, conspiring with Villalba to defraud the plaintiffs. Count four alleges a breach of a fiduciary duty that the defendants owed to the plaintiffs. By count five, the plaintiffs allege that defendant Rosenthal Collins violated a duty to supervise, monitor, and investigate its agents, namely defendants McDonnell and McDonnell Futures. Counts six and seven are for unjust enrichment and conversion.

LAW AND ANALYSIS

Federal preemption

As grounds for dismissing all of the plaintiffs' causes of action Rosenthal Collins posits that every claim is preempted by the federal Commodity Exchange Act, *7 U.S.C. §1 et seq.*

HN1 It is well-established that three types of federal preemption exist, one express and two implied. *Bibbo v. Dean Witter Reynolds, Inc., 151 F.3d 559, 562 (6th Cir. Ohio 1998)*. Express preemption exists when Congress expresses a clear intent to preempt state law in the language of the statute. *Id.* The first type of implied preemption, field preemption, is implicit [*7] where Congress indicates an intent to occupy exclusively an entire field of regulation; that intent is inferred, for example, from a federal regulatory scheme that is "so pervasive as to make reasonable the inference that [it] left no room for the states to supplement it." *Id.* The second type of implied preemption, conflict preemption, occurs either where it is impossible to comply with both federal and state law, or where state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress" as reflected in the language, structure and underlying goals of the federal statute at issue. *Id.*

Rosenthal Collins argues that field preemption exists here.

HN2 The Commodity Exchange Act is found at *7 U.S.C. 1-27f*. *Section 2(a)(1)(A)* confers jurisdiction on the Commodities Futures Trading Commission "with respect to accounts, agreements . . . and transactions involving swaps or contracts of sale of a commodity for future delivery . . . traded or executed on a contract market designated pursuant to *section 7* of this title or a swap execution facility." But that section also provides that "nothing contained in this section shall supersede or limit the [*8] jurisdiction conferred on courts of the United States or any state." This suggests that Congress intended to comprehensively regulate activities directly related to commodity markets but left conduct of the participants in those markets not directly connected to a transaction open to additional federal or state regulation, including common law remedies. The CEA then is not a "regulatory scheme that is so pervasive as to make reasonable the inference that [it] left no room for the states to supplement it." *Bibbo, supra.*

Federal trial courts have concurred. For example, *Sall v. G.H. Miller & Co., 612 F. Supp. 1499 (D. Colo. 1985)*, cited by Rosenthal Collins in support of its preemption argument, involved plaintiffs suing a commodities broker they used to trade in commodity futures. Their complaint asserted causes of action under the CEA and state law claims for breach of fiduciary duty, fraudulent concealment, constructive fraud, negligent supervision and breach of contract. The court, addressing the defendant's preemption argument, found that although the legislation was comprehensive, the "legislative history of the CEA and its amendments clearly evinces an intent to preempt *state regulation* [*9] *of commodities markets* but not to preempt all state common law remedies." *Id., at 1504* (emphasis added).

If that conclusion is correct in a case brought by the broker's own customer, it is even more apt in this case, where the plaintiffs were the clients of the investment adviser and never dealt directly with the broker. As in *Sall*, the plaintiffs' state statutory and common law claims are not preempted by the CEA and the motion to dismiss on that basis is denied.

Aiding and participating in securities fraud

Count one of the amended complaint alleges that the defendants are liable for aiding and abetting Villalba's securities fraud. *HN3* R.C. 1707.43 provides that "every person that has participated in or aided the seller in any way in making" a sale in violation of R.C. Chapter 1707 is "jointly and severally liable to the purchaser" for the return of the purchase price of the security or contract at issue. Rosenthal Collins first contends that it cannot be liable because the trades the defendant cleared were for commodities, which are not covered by Ohio's security laws. The plaintiffs counter that Villalba was engaged in the sale of securities, namely "investment contracts," making Rosenthal [*10] Collins an abettor even if Rosenthal Collins was only directly involved in the commodity trades made after Villalba sold the securities.

R.C. 1707.01(B) defines securities that are covered by Chapter 1707 to include "any investment contract." There is an "investment contract" when (1) an offeree furnishes initial value to an offeror, and (2) a portion of this initial value is subjected to the risks of the enterprise, and (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise. *State v. George, 50 Ohio App. 2d 297, 302, 362 N.E.2d 1223 (10th Dist. 1975)*.

Here there is no question that the plaintiffs (the offerees) furnished initial value, in the form of their money, to the offeror (Villalba). It also cannot be disputed that the plaintiffs furnished that value because of Villalba's promises of exceptional profits through investment of the money.

[*11] Therefore the first and third parts of the test are easily satisfied.

The second part of the test requires at least a portion of the initial value, i.e. the plaintiffs' money, to be "subjected to the risks of the enterprise." Stated another way, the question here is whether such investment would become a part of the capital pool used to conduct the business being promoted by the offeror. *George, supra, 303*. *HN4* The "enterprise" of an investment manager is to invest clients' money with the expectation of receiving a return on that capital. In this case, the enterprise was Villalba's investment of the funds using his money market plus method. An inevitable feature of such an enterprise is that the funds are subjected to its risks. Despite Rosenthal Collins's suggestion to the contrary [3], there is nothing about the definition of an investment contract that requires the funds of more than one person to be pooled to satisfy this part of the test. Villalba could have conducted a single enterprise using the funds of the three plaintiffs combined or he could have conducted three separate enterprises with the separate funds of each plaintiff.

As long as the money invested is subject to the risks [*12] of the enterprise, which it was here, the presence of one investor is enough. Besides, as a practical matter, it is alleged that the funds of all plaintiffs were pooled. Hence, the plaintiffs have met the second part of the test.

HN5 The last part of the test can be satisfied only if the plaintiffs did not have the right to exercise practical and actual control over the managerial decisions of the enterprise. This part of the test exists because the absence of direct control over the investment by the investor is traditionally an essential feature of a "security." *George, supra, 304*. The fourth prong does not require an examination of whether the investor actually managed or controlled the investment, but whether it had the right to do so. *Pride of the Andes, Inc. v. Soberay, 9th Dist. No. 3062-M, 2001 Ohio App. LEXIS 36 (Jan. 10, 2001)*.

The investment management agreement that each plaintiff [4] had with Villalba includes provisions giving Villalba "full and exclusive discretionary [*13] authority to invest and

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[3] Reply brief in support of motion to dismiss, page 4: In the instant case there is no enterprise: rather, all Villalba agreed to do was provide management services for each individual plaintiff: their money was never agreed to be pooled.

[4] Only the agreement of VASA National Archives and a portion of the VASA agreement are part of the pleadings — as exhibits to the

reinvest the [plaintiffs'] assets" [5] and "complete and unlimited discretionary trading authorization." [6] The plaintiffs also gave Villalba "sole discretion, and at [the plaintiffs'] risk [to] purchase, sell, exchange, convert, tender and otherwise trade securities in the account and to act on behalf of [the plaintiffs] in all other matters necessary or incidental to the account." [7] While it is true that the agreement also allows the plaintiffs "to perform services similar to, or impacting on' [8] Villalba's responsibilities and to "designate that brokerage transactions be directed to a specific broker," [9] these terms at most create an issue of fact on the question of whether the plaintiffs had the right to exercise practical and actual control over the managerial decisions. The plaintiffs have therefore, in the context of a motion to dismiss, established the fourth prong and the defendant's argument that the plaintiffs' investment contracts with Villalba were not securities is not persuasive.

Next, because Money Market Alternative, L.P., not the plaintiffs, had an account with the defendant, Rosenthal Collins asserts that the plaintiffs lack standing to assert any claim against it. Instead, according to the defendant, any claim should be brought by Villalba's company, Money Market Alternatives, L.P. Yet Money Market Alternatives was only the nominal purchaser; it was the plaintiffs' account that was being used and the plaintiffs who incurred damages. Moreover, the defendant's position would result in the absurdity that Money Market Alternatives — an entity apparently owned by Villalba, who committed the fraud — must sue Rosenthal Collins for aiding and abetting Villalba's own fraud. It would be an injustice to leave to Villalba, the primary tortfeasor, the decision to [*15] sue to recover the plaintiffs' money from a joint tortfeasor.

Rosenthal Collins's final reason to dismiss the aiding and abetting claim is that the plaintiffs have failed to adequately plead the elements of Section 1707.43. As for this argument, the court can only note that Villalba's fraud, and the defendant's knowledge of it, are set forth in detail in the amended complaint and that the plaintiffs are not required to prove actual fraud or intent by Rosenthal Collins. (See, *e.g.*, *Fed. Mgmt. Co. v. Coopers & Lybrand, 137 Ohio App. 3d 366, 391, 738 N.E.2d 842 (10th Dist. 2000)*: ***HN6*** R.C. 1707.43 does not require that a person induce a purchaser to invest in order to be held liable. Rather, the language is very broad, and participating in the sale or aiding the seller *in any way* is sufficient to form a basis for liability under R.C. 1707.43.) Therefore, the amended complaint adequately informs Rosenthal Collins of the claim it is expected to defend itself against.

Aiding and abetting Villalba's tortious conduct

Rosenthal Collins argues that this claim should be dismissed because it is not clear that such a cause of action even exists in Ohio, but if it does it has not been pled with sufficient particularity. [*16] Addressing the second part of this objection first, as noted above the plaintiffs have described the alleged wrongdoing sufficiently to withstand a motion to dismiss. As to the first part, the court acknowledges ***HN7*** uncertainty about whether the cause of action is viable in Ohio. [10] However, if it does exist it certainly requires more culpability than the R.C. 1707.43 claim and discovery revealing that the defendant had no knowledge of Villalba's fraud may make it unnecessary for the court to decide whether to allow the cause of action. So, that objection can be addressed as part of a future dispositive motion but is not yet justiciable.

Civil conspiracy

HN8 In order to establish the tort of civil conspiracy, a plaintiff must prove the following elements: (1) a malicious combination of two or more persons, (2) causing injury to another person or property, and (3) the existence of an unlawful act independent from the conspiracy itself. *Kenty v. TransAmerican Premium Ins. Co., 72 Ohio St. 3d 415, 419, 1995 Ohio 61, 650 N.E.2d 863 (1995)*. [*17] The

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defendant's 11/04/2011 reply brief. It is [*14] assumed that the missing parts of the VASA agreement are the same as the VASA National Archives agreement and also that Bergman's agreement is not different. The court has considered these post-complaint filings in connection with the motion to dismiss since they should have been filed with the complaint.

[5] Investment management agreement, section II(A).

[6] Id., section X.

[7] Id.

[8] Id., section I.

[9] Id., section II(B).

[10] *Sekerak v. Nat'l City Bank, 342 F. Supp. 2d 701, 716 (N.D. Ohio 2004)* summarizes Ohio's conflicting decisional authority. Ultimately, the question is whether Ohio follows Section 876(b) of the Restatement of the Law 2d, Torts (1979).

defendant's argument against this claim is essentially factual: that Rosenthal Collins "never agreed to any such combination" [11] and "there was nothing malicious about" [12] the work it did for Villalba. But that argument is best addressed on summary judgment. In the context of a motion to dismiss, a review of the amended complaint shows that it sufficiently alleges facts which, if true, entitle the plaintiffs to relief from Rosenthal Collins.

Breach of fiduciary duty

Count IV of the amended complaint asserts that Rosenthal Collins breached a fiduciary duty owed to the plaintiffs by not detecting and putting an end to Villalba's fraud. *HN9* The three elements of a breach of fiduciary duty claim are the existence of a duty arising from a fiduciary relationship, a failure to observe the duty, and an injury resulting proximately therefrom. *DeJohn v. DiCello, 8th Dist. No. 94785, 2011 Ohio 471, ¶29-32*. A fiduciary relationship is one in which special confidence and trust is reposed in the integrity and fidelity of another and there is a resulting position of superiority or influence, acquired by virtue of this special trust. *Tornado Techs., Inc. v. Quality Control Inspection, Inc., 8th Dist. No. 97514, 2012 Ohio 3451, ¶25, 977 N.E.2d 122*. [*18] A fiduciary relationship may be created out of an informal relationship only when both parties understand that a special trust or confidence has been reposed. *Id., ¶26*. Thus, a fiduciary relationship cannot be unilateral; it must be mutual. *Id.*

While Villalba and the plaintiffs were in a fiduciary relationship, Rosenthal Collins and the plaintiffs were not. Rosenthal Collins was employed by Villalba's company to clear transactions on the commodities market. Even assuming the defendant's complicity with Villalba's deception, there is nothing about Rosenthal Collins's role that suggests that the plaintiffs reposed special confidence and trust in Rosenthal Collins in particular, much less that the defendant mutually understood and accepted that trust. The plaintiffs essentially concede the lack of a separate fiduciary duty owed by these defendants by alleging, at paragraph 98 of the amended complaint, that the defendants "participated in and aided Villalba's breaches of duties owed to plaintiffs."

Count IV of the amended complaint should thus be dismissed for lack of a fiduciary relationship between Rosenthal Collins and the plaintiffs.

Negligent supervision, monitoring and investigation

The [*19] plaintiffs allege at Count V of the amended complaint that Rosenthal Collins violated "duties to supervise, monitor and investigate its agents, including Defendants McDonnell and/or McDonnell Futures." In support of the existence of such a duty in this case the plaintiffs cite to *Javitch v. First Montauk Fin. Corp., 279 F. Supp. 2d 931 (N.D. Ohio 2003)*.

The primary wrongdoer in *Javitch* was Capwill. Capwill solicited investors' money and then used it to open brokerage accounts in his own clients' names at First Montauk through First Montauk's agent, Giarmoleo. The funds belonged to Capwill's clients and the accounts were in their own names. However, Giarmoleo took his instructions on the use of the money from Capwill, who then used the accounts in violation of his own duty to the clients because he had agreed to keep the investors' money in escrow. The lawsuit at issue included a cause of action by the receiver of Capwill's business entities against, among others, First Montauk for its failure to supervise Giarmoleo.

That lawsuit involves a circumstance not present here, namely a direct customer relationship between First Montauk and the defrauded investors. That distinction is enough [*20] to defeat the existence of a duty here. Under the facts alleged in the second amended complaint, this court cannot find that Rosenthal Collins undertook a duty in favor of these plaintiffs to "supervise, monitor and investigate" McDonnell and his company.

Unjust enrichment

By this cause of action, at Count VI of the amended complaint, the plaintiffs claim that Rosenthal Collins has "been unjustly enriched" and should pay restitution to the plaintiffs in the form of "all sums originally invested plus all commissions and fees paid" to Rosenthal Collins.

HN10 The elements of unjust enrichment include: 1) a benefit conferred by a plaintiff upon a defendant; 2) knowledge by the defendant of the benefit; and 3) retention of the benefit by the defendant under circumstances where it would be unjust to do so without payment. *Emswiler v. Bodey, 2d Dist. No. 2012 CA 3, 2012 Ohio 5533, ¶50*. In this case it would only be "unjust" for Rosenthal Collins to retain fees that came from the plaintiffs' money if Rosenthal Collins actually participated in the wrongdoing, i.e. if any of the plaintiffs' other substantive claims are found to have merit. But in that event the plaintiffs will already be entitled

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[11] Br. in opp., p. 10.

[12] Id.

to [*21] a recovery on one or more of the alternative tort claims. Hence, the equitable claim for unjust enrichment is not an alternative theory of recovery but redundant of the tort grounds for recovery and should be dismissed.

It's also worth noting, in passing, that any benefit retained by Rosenthal would at most be equal to its fees, and not "all sums originally invested" and lost by the plaintiffs.

Conversion

The last claim in the amended complaint is for conversion. ***HN11*** Conversion is a wrongful exercise of dominion over property in exclusion of the right of the owner, or withholding it from his possession under a claim inconsistent with his rights. *Gurry v. C.P., 8th Dist. No. 97815, 2012 Ohio 2640, ¶18, 972 N.E.2d 154*. The elements for conversion are plaintiffs' ownership or interest in the property; plaintiffs' actual or constructive possession or immediate right to possession of the property; defendant's wrongful interference with plaintiffs' property rights; and damages. *Id.*

HN12 Ordinarily a claim for conversion involves an identifiable piece of property, not cash. To maintain a conversion claim involving currency, a party must demonstrate that the money was (1) delivered for safekeeping, (2) intended to be [*22] segregated, (3) remained in substantially the form in which it was received, and (4) not subject to a title claim by the keeper. *FinishMaster, Inc. v. Richard's Paint & Body Shop, LLC, W.D. Tex. No. A-11-CA-560 AWA, 2012 U.S. Dist. LEXIS 93681 (July 6, 2012)*.

The property the plaintiffs allege that Rosenthal Collins converted is "monies provided to Villalba." [13] This claim illustrates one of the reasons that money can only be converted under the circumstances set out in *Finishmaster*. Even if it is assumed that some of the fees paid to Rosenthal Collins were derived from the plaintiffs' cash the plaintiffs have not alleged any way to account for the amount attributable to them since they also allege that their money was commingled with other investors' money.

Count VII of the amended complaint fails to state a claim and should be dismissed.

CONCLUSION

For all of the reasons given in this entry, the motion to dismiss the amended complaint filed by defendant Rosenthal Collins on August 26, 2011 is granted on the plaintiffs' claims for breach of fiduciary duty (Count IV), negligent supervision, monitoring and investigation (Count V), unjust enrichment (Count VI) and conversion [*23] (Count VII). The motion is denied on all other causes of action: aiding and abetting securities fraud pursuant to *R.C. 1707.43* (Count I), aiding and abetting fraud (Count II) and civil conspiracy (Count III).

IT IS SO ORDERED:

Date: January 29, 2013

JUDGE JOHN P. O'DONNELL

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[13] Am. comp., ¶107.

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IN THE COURT OF COMMON PLEAS
CUYAHOGA COUNTY, OHIO

VASA ORDER OF AMERICA, ETA L
Plaintiff

ROSENTHAL COLLINS GROUP, L.L.C., ET AL
Defendant

Case No: CV-11-753705

Judge: JOHN P O'DONNELL

JOURNAL ENTRY

DEFENDANT ROSENTHAL COLLINS GROUP, L.L.C.'S MOTION FOR SUMMARY JUDGMENT IN ITS FAVOR ON ALL OF THE PLAINTIFFS' CAUSES OF ACTION, FILED 12/05/2014, IS GRANTED AND DENIED IN PART.

THE MOTION IS GRANTED ON THE COMMON LAW CAUSE OF ACTION FOR AIDING AND ABETTING TORTIOUS CONDUCT.

THE MOTION IS GRANTED ON THE CAUSE OF ACTION FOR CIVIL CONSPIRACY.

THE MOTION IS DENIED ON THE CAUSE OF ACTION FOR AIDING AND ABETTING SECURITIES FRAUD UNDER R.C. 1707.43.

Judge Signature 09/25/2015

09/25/2015

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IN THE COURT OF COMMON PLEAS
CUYAHOGA COUNTY, OHIO

VASA ORDER OF AMERICA, ETA L
Plaintiff

ROSENTHAL COLLINS GROUP, L. L.C., ET AL
Defendant

Case No: CV-11-753705

Judge: JOHN P O'DONNELL

JOURNAL ENTRY

DEFENDANT ROSENTHAL COLLINS GROUP, LLC'S MOTION IN LIMINE TO EXCLUDE EVIDENCE ABOUT THE TRADING ACTIVITY IN THE MONEY MARKET ACCOUNT AND OF THE DEFENDANT'S ALLEGED FAILURE TO MONITOR THE ACCOUNT, FILED 04/28/2015, IS DENIED. THAT CONDUCT, IF PROVEN, CAN FALL WITHIN THE RUBRIC OF "AIDING AND ABETTING."

Judge Signature 09/26/2015

09/25/2015

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IN THE COURT OF COMMON PLEAS
CUYAHOGA COUNTY, OHIO

VASA ORDER OF AMERICA, ETA L
Plaintiff

ROSENTHAL COLLINS GROUP, L. L.C., ET AL
Defendant

Case No: CV-11-753705

Judge: JOHN P O'DONNELL

JOURNAL ENTRY

ON OCTOBER 13, 2015, ALL PARTIES AND COUNSEL WERE PRESENT IN OPEN COURT (WITH COURT REPORTER BOB INTORCIO) AND THE JURY RETURNED INTERROGATORIES FINDING THAT DEFENDANT ROSENTHAL COLLINS PARTICIPATED IN OR AIDED IN THE ILLEGAL SALE OF SECURITIES TO THE PLAINTIFFS AND, ACCORDINGLY, RETURNED THREE SEPARATE VERDICTS IN FAVOR OF THE THREE SEPARATE PLAINTIFFS.

DEFENDANT ROSENTHAL COLLINS THEN MADE AN ORAL MOTION FOR JUDGMENT NOTWITHSTANDING THE VERDICT UNDER RULE 50(B) OF THE OHIO RULES OF CIVIL PROCEDURE. THE PARTIES WERE INFORMED THAT I WILL NOT RULE ON AN ORAL MOTION WITHOUT WRITTEN BRIEFS, AND THE DEFENDANT IS GIVEN LEAVE UNTIL DECEMBER 14, 2015, TO FILE A WRITTEN MOTION FOR JUDGMENT NOTWITHSTANDING THE VERDICT WITH A BRIEF IN SUPPORT.

THE PLAINTIFFS' BRIEF IN OPPOSITION AND THE DEFENDANTS' REPLY ARE DUE WITHIN THE TIME LIMITS SET OUT IN CIVIL RULE 50(B), BUT ANY STIPULATED EXTENSION OF THOSE DEADLINES WILL BE ADOPTED BY THE COURT.

I INTEND TO DEFER A FINAL ENTRY OF JUDGMENT UNTIL AFTER THE MOTION FOR A NEW TRIAL IS DECIDED.

COURT COST ASSESSED AS DIRECTED.

Judge Signature 10/13/2015

10/13/2015

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Current through Legislation passed by the 131st General Assembly and filed with the Secretary of State through file 24 (HB 238).

§ 1707.43 Remedies of purchaser in unlawful sale.

(A) Subject to divisions (B) and (C) of this section, every sale or contract for sale made in violation of Chapter 1707. of the Revised Code, is voidable at the election of the purchaser. The person making such sale or contract for sale, and every person that has participated in or aided the seller in any way in making such sale or contract for sale, are jointly and severally liable to the purchaser, in an action at law in any court of competent jurisdiction, upon tender to the seller in person or in open court of the securities sold or of the contract made, for the full amount paid by the purchaser and for all taxable court costs, unless the court determines that the violation did not materially affect the protection contemplated by the violated provision.

(B) No action for the recovery of the purchase price as provided for in this section, and no other action for any recovery based upon or arising out of a sale or contract for sale made in violation of Chapter 1707. of the Revised Code, shall be brought more than two years after the plaintiff knew, or had reason to know, of the facts by reason of which the actions of the person or director were unlawful, or more than five years from the date of such sale or contract for sale, whichever is the shorter period.

(C) No purchaser is entitled to the benefit of this section who has failed to accept, within thirty days from the date of such offer, an offer in writing made after two weeks from the date of the sale or contract of sale, by the seller or by any person that has participated in or aided the seller in any way in making the sale or contract of sale, to take back the security in question and to refund the full amount paid by the purchaser.

Rev. Code Wash. (RCW) § 21.20.430

Statutes current through 2015 3rd Special Session

21.20.430. Civil liabilities — Survival, limitation of actions — Waiver of chapter void — Scienter.

(1) Any person, who offers or sells a security in violation of any provisions of *RCW 21.20.010*, *21.20.140 (1)* or (2), or 21.20.180 through 21.20.230, is liable to the person buying the security from him or her, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at eight percent per annum from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he or she no longer owns the security. Damages are the amount that would be recoverable upon a tender less (a) the value of the security when the buyer disposed of it and (b) interest at eight percent per annum from the date of disposition.

(2) Any person who buys a security in violation of the provisions of *RCW 21.20.010* is liable to the person selling the security to him or her, who may sue either at law or in equity to recover the security, together with any income received on the security, upon tender of the consideration received, costs, and reasonable attorneys' fees, or if the security cannot be recovered, for damages. Damages are the value of the security when the buyer disposed of it, and any income received on the security, less the consideration received for the security, plus interest at eight percent per annum from the date of disposition, costs, and reasonable attorneys' fees.

(3) Every person who directly or indirectly controls a seller or buyer liable under subsection (1) or (2) above, every partner, officer, director or person who occupies a similar status or performs a similar function of such seller or buyer, every employee of such a seller or buyer who materially aids in the transaction, and every broker-dealer, salesperson, or person exempt under the provisions of *RCW 21.20.040* who materially aids in the transaction is also liable jointly and severally with and to the same extent as the seller or buyer, unless such person sustains the burden of proof that he or she did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist. There is contribution as in cases of contract among the several persons so liable.

(4)

(a) Every cause of action under this statute survives the death of any person who might have been a plaintiff or defendant.

(b) No person may sue under this section more than three years after the contract of sale for any violation of the provisions of *RCW 21.20.140 (1)* or (2) or 21.20.180 through 21.20.230, or more than three years after a violation of the provisions of *RCW 21.20.010*, either was discovered by such person or would have been discovered by him or her in the exercise of reasonable care. No person may sue under this section if the buyer or seller receives a written rescission offer, which has been passed upon by the director before suit and at a time when he or she owned the security, to refund the consideration paid together with interest at eight percent per annum from the date of payment, less the amount of any income received on the security in the case of a buyer, or plus the amount of income received on the security in the case of a seller.

(5) No person who has made or engaged in the performance of any contract in violation of any provision of this chapter or any rule or order hereunder, or who has acquired any purported right under any such contract with knowledge of the facts by reason of which its making or performance was in violation, may base any suit on the contract. Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this chapter or any rule or order hereunder is void.

(6) Any tender specified in this section may be made at any time before entry of judgment.

(7) Notwithstanding subsections (1) through (6) of this section, if an initial offer or sale of securities that are exempt from registration under *RCW 21.20.310* is made by this state or its agencies, political subdivisions, municipal or quasi-municipal corporations, or other instrumentality of one or more of the foregoing and is in violation of *RCW 21.20.010(2)*, and any such issuer, member of the governing body, committee member, public officer, director, employee, or agent of such issuer acting on its behalf, or person in control of such issuer, member of the governing body, committee member, public officer, director, employee, or agent of such person acting on its behalf, materially aids in the offer or sale, such person is liable to the purchaser of the security only if the purchaser establishes scienter on the part of the defendant. The word "employee" or the word "agent," as such words are used in this subsection, do not include a bond counsel or an underwriter. Under no circumstances whatsoever shall this subsection be applied to require purchasers to establish scienter on the part of bond counsels or underwriters. The provisions of this subsection are retroactive and apply to any action commenced but not final before July 27, 1985. In addition, the provisions of this subsection apply to any action commenced on or after July 27, 1985.

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the requirements of paragraph (b)(1)(ii) of this section;

(v) Specify the relief sought under paragraph (b)(2) of this section;

(vi) Be signed by the pool operator, as follows: If the pool operator is a sole proprietorship, the request must be signed by the sole proprietor; if a partnership, by a general partner; and if a corporation, by the chief executive officer or chief financial officer; and

(vii) Be filed, along with a copy, with the Commission at the address specified in § 4.2.

(viii) A copy also must be filed with the National Futures Association at its headquarters office (Attn: Director of Compliance, Compliance Department).

(4)(i) The claim of exemption must be filed before the date the commodity pool first enters into a commodity interest transaction.

(ii) The claim of exemption shall be effective upon filing; *Provided, however,* That any exemption claimed hereunder shall cease to be effective upon any change which would render the representations made pursuant to paragraph (b)(3)(iv) of this section inaccurate or the continuation of such representations false or misleading.

(5)(i) If a claim of exemption has been made under § 4.12(b)(2)(i), the commodity pool operator must make a statement to that effect on the cover page of each offering memorandum, or amendment thereto, that it is required to file with the Commission pursuant to § 4.26.

(ii) If a claim of exemption has been made with respect to paragraph (b)(2)(iii) of this section, the pool operator must make a statement to that effect on the cover page of each annual report that it is required to file with the Commission pursuant to § 4.22(c).

(6)(i) Any claim of exemption effective hereunder shall be effective only with respect to the pool for which it has been made.

(ii) The effectiveness of such claim shall not affect the obligations of the commodity pool operator to comply with all other applicable provisions of this part 4, the Act and the Commission's rules and regulations issued thereunder with respect to the pool and any other pool the pool operator operates or intends to operate.

[52 FR 41984, Nov. 2, 1987, as amended at 60 FR 38183, July 25, 1995]

§ 4.13 Exemption from registration as a commodity pool operator.

(a) A person is not required to register under the Act as a commodity pool operator if:

(1)(i) It does not receive any compensation or other payment, directly or indirectly, for operating the pool, except reimbursement for the ordinary administrative expenses of operating the pool;

(ii) It operates only one commodity pool at any time;

(iii) It is not otherwise required to register with the Commission and is not a business affiliate of any person required to register with the Commission; and

(iv) Neither the person nor any other person involved with the pool does any advertising in connection with the pool (for purposes of this section, advertising includes the systematic solicitation of prospective participants by telephone or seminar presentation); or

(2)(i) The total gross capital contributions it receives for units of participation in all of the pools that it operates or that it intends to operate do not in the aggregate exceed $200,000; and

(ii) None of the pools operated by it has more than 15 participants at any time. For purposes of computing the number of participants for paragraph (a)(2)(ii) of this section, the following participants shall be excluded:

(A) The pool's operator, commodity trading advisor, and the principals thereof; and

(B) Any relative, spouse or relative of such spouse living in the same household as such participant.

(b)(1) No person who is exempt from registration as a commodity pool operator under paragraph (a)(1) or (a)(2) of this section and who is not registered as such pursuant to that exemption may, directly or indirectly, solicit, accept or receive funds, securities or other property from any prospective participant in a pool that it operates or that it intends to operate unless, on or before the date it engages in that activity, the person delivers or causes to be delivered to the prospective participant a written statement that must disclose this fact as follows: "The commodity pool operator of this pool is not required to register, and has not registered, with the Commodity Futures Trading Commission. Therefore, unlike a registered commodity pool operator, this commodity pool operator is not required by the Commission to furnish a Disclosure Document, periodic Account Statements, and an Annual Report to participants in the pool." The person must:

(i) Describe in the statement the exemption pursuant to which it is not registered as a commodity pool operator;

(ii) Provide its name, main business address and main business telephone number on the statement;

(iii) Manually sign the statement as follows: if such person is a corporation, by the chief executive officer, chief financial officer or counterpart thereto; if a partnership, by a general partner; and if a sole proprietorship, by the sole proprietor; and

(iv) By the earlier of seven business days after the date the statement is first delivered to a prospective participant and the date upon which the pool commences trading in commodity interests:

(A) File two copies of the statement with the Commission at the address specified in §4.2; and

(B) File one copy of the statement with the National Futures Association at its headquarters office (Attn: Director of Compliance, Compliance Department).

(2) Each person who is exempt from registration as a commodity pool operator under paragraph (a)(1) or (a)(2) of this section and who is not registered as such pursuant to that exemption must:

(i)(A) Promptly furnish to each participant in each pool that it operates a copy of the monthly statement for the pool that such person received from a futures commission merchant pursuant to §1.33, and

(B) Clearly show on such statement, or on an accompanying supplemental statement, the net profit or loss on all commodity interests closed since the date of the previous statement; and

(ii)(A) Maintain all books and records prepared in connection with its activities as a commodity pool operator for a period of five years from the date of preparation, and

(B) Keep such books and records readily accessible during the first two years of the five-year period. All such books and records shall be open to inspection by any representative of the Commission or the United States Department of Justice.

(c) Each person who applies for registration as a commodity pool operator must include with its initial application the financial statements and other information required by §4.22(c) (1) through (5) for each pool it operates when such application is made. That information must be presented and computed in accordance with generally accepted accounting principles consistently applied. If the person is granted registration as a commodity pool operator, it must comply with this part 4 with respect to each pool it operates. The provisions of this paragraph (c) shall apply even though such person was exempt from registration as a commodity pool operator pursuant to the provisions of paragraph (a) of this section at the time it applied for registration.

(d) If a person exempt from registration under the Act as a commodity pool operator under paragraph (a)(1) or (a)(2) of this section registers as a commodity pool operator, that person must comply with this part 4 as if such person were not exempt from registration as a commodity pool operator.

(Approved by the Office of Management and Budget under control number 3038–0005)

(Secs. 2(a)(1), 4c(a)–(d), 4d, 4f, 4g, 4k, 4m, 4n, 8a, 15 and 17, Commodity Exchange Act (7 U.S.C. 2, 4, 6c(a)–(d), 6f, 6g, 6k, 6m, 6n, 12a, 19 and 21; 5 U.S.C. 552 and 552b))

[46 FR 26013, May 8, 1981, as amended at 46 FR 63035, Dec. 30, 1981; 47 FR 57011, Dec. 22, 1982; 50 FR 15883, Apr. 23, 1985]

§4.14 Exemption from registration as a commodity trading advisor.

(a) A person is not required to register under the Act as a commodity trading advisor if:

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Notice I-97-25
November 03, 1997

The Filing of Exclusion and Exemption Notices Pursuant to CFTC Regulations 4.5, 4.7, 4.12(b), 4.13, 4.14(a)(8), and Advisory 18-96.

Effective November 1, 1997, NFA is authorized to process the following filings, notices and claims allowed by the CFTC Regulations listed below:

1) Notices of eligibility for exclusion for certain otherwise regulated persons from the definition of CPO, pursuant to Regulation 4.5;

2) Notices of claim for exemption from certain Part 4 requirements with respect to commodity pools and CTAs whose participants or clients are qualified eligible participants or qualified eligible clients, respectively, pursuant to Regulation 4.7;

3) Claims of exemption from certain Part 4 requirements for CPOs with respect to pools that principally trade securities, pursuant to Regulation 4.12(b);

4) Statements of exemption from registration as a CPO, pursuant to Regulation 4.13;

5) Notices of exemption from registration as a CTA for certain persons registered as an investment advisor, pursuant to Regulation 4.14(a)(8);

6) Notices of claim for exemption from provisions of Part 4 for certain registered CPOs operating offshore pools, pursuant to Advisory 18-96.

Individuals and/or entities that are subject to any of the above mentioned exemptions should send the required notices to National Futures Association at 200 West Madison Avenue, Chicago, Illinois 60606, Attn: Compliance Department. In addition, copies of all notices or claims filed with NFA should continue to be filed with the CFTC.

NFA will review all filings in accordance with the standards established by Part 4 of the regulations. Those filings that comply with said regulations will be accepted upon filing. For those filings that don't comply, NFA staff will notify the party that submitted the notice of any deficiencies by letter.

If you have any questions regarding this notice, please contact Maria McHenry of NFA's Compliance Department at (312) 781- 2237.

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NFA Manual / Rules

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Bylaws

BYLAW 1101. PROHIBITION.
[Effective dates of amendments: July 27, 1983; January 1, 1990; and August 21, 2001.]

No Member may carry an account, accept an order or handle a transaction in commodity futures contracts for or on behalf of any non-Member of NFA, or suspended Member, that is required to be registered with the Commission as an FCM, IB, CPO, CTA or LTM, and that is acting in respect to the account, order or transaction for a customer, a commodity pool or participant therein, a client of a commodity trading advisor, or any other person, unless:

(a) such non-Member of NFA is a member of another futures association registered with the Commission under Section 17 of the Act, or is exempted from this prohibition by Board resolution;

(b) such non-Member of NFA is registered with the Commission as an FCM or IB under Section 4f(a)(2) of the Act and the account, order, or transaction involves only security futures products; or

(c) such suspended Member is exempted from this prohibition by the Appeals Committee.

No Member may accept orders in commodity futures contracts to cover leverage transactions, for or on behalf of any non-Member of NFA, or suspended Member, that is required to be registered with the Commission as an LTM, unless:

(a) such non-Member is a member of another futures association registered under Section 17 of the Act, or is exempted from this prohibition by Board resolution; or

(b) such suspended Member is exempted from this prohibition by the Appeals Committee.

(See Interpretive Notice Compliance with NFA Bylaw 1101.)

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9007 - COMPLIANCE WITH NFA BYLAW 1101

(Staff, March 19, 1987; revised July 1, 2000)

INTERPRETIVE NOTICE

Mandatory membership in NFA is the cornerstone of NFA's regulatory structure. From the earliest stages of its formation, NFA's founders recognized that the creation of a meaningful and effective industrywide self-regulatory organization would be completely impossible unless all persons required to be registered as FCMs, IBs, CPOs or CTAs were required to be Members. The founders of NFA considered the issue to be of such critical importance that they not only prohibited the conduct of customer business with non-Members through NFA Bylaw 1101, but included that prohibition as one of NFA's fundamental purposes in Article III, Section 1(f) of NFA's Articles of Incorporation.

Given the importance of the mandatory membership concept, NFA Bylaw 1101, which tracks the language of Article III, Section 1(f), states the prohibition in the strongest possible terms. [See Bylaw 1101.]

The rule by its terms imposes strict liability on any Member conducting customer business with a non-Member that is required to be registered. The rule does not require proof that the Member firm was at fault or failed to exercise due diligence, simply that it transacted customer business with a non-Member that is required to be registered. NFA Bylaw 1101 requires Members to make two determinations: whether it is doing business with an entity which is required to be registered, and if so, whether that person is a Member of NFA. The second of these determinations is relatively simple. Any Member can check the BASIC system on NFA's web site at www.nfa.futures.org, send a request to NFA through the "contact" feature of the web site, or call NFA's Information Center at a toll-free number (800) 621-3570 to receive current and accurate information concerning the membership status of any person. The determination of whether a particular person is required to be registered can obviously be much more difficult. Any Member could, despite its best efforts, be transacting customer business with a person who is actually required to be registered as an FCM, IB, CPO or CTA. In such a case, the Member is in technical violation of the strict liability terms of NFA Bylaw 1101.

A review of NFA policy, procedures and past disciplinary actions, however, clearly indicates that NFA Bylaw 1101 has not been enforced unreasonably. In making its recommendations in cases involving apparent Bylaw 1101 violations, staff has consistently not relied on the strict liability standard set by the rule itself. Staff has recommended the issuance of complaints in Bylaw 1101 cases in which the evidence indicates that the Member knew or should have known of the violation. Of course, under NFA Compliance Rules, the ultimate decision of whether a particular violation of NFA Rules warrants prosecution rests with the Members of NFA's Business Conduct Committee ("BCC"). BCC Members exercise their informed business judgment in making these decisions, and are certainly aware that some violations of Bylaw 1101 may occur in spite of reasonably diligent efforts to comply with the rule.

The question of whether a Member should have known of a violation of NFA Bylaw 1101 depends in large part on the adequacy of its procedures to prevent such violations. Though it would be impossible to describe all of the situations which should put a Member on notice that a particular person is required to be a Member or NFA, there are certain minimal steps which should be taken to reduce the possibility of a violation of NFA Bylaw 1101:

1. FCM Members should ensure that all omnibus accounts they carry are held by FCM Members of NFA;
2. Each Member should review the list of CFTC registrants with which it does business to determine if they are NFA Members. A Member can determine whether a particular entity is a CFTC registrant by checking the BASIC system on NFA's web site located at www.nfa.futures.org, sending a request to NFA through the "contact" feature on the web site, or calling NFA's Information Center toll-free at (800) 621-3570.
3. Each Member should review its list of customers. If a customer's name indicates that it may be engaged in the futures business, the Member should inquire as to its registration and membership status;
4. When a FCM or IB Member carries an account controlled by a third party (other than an AP of the FCM or IB or a member of the same family as the account owner), the FCM or IB Member should check to see if the account controller is registered as a CTA and, if not registered, should inquire as to the basis of any exemption and, if applicable, should verify that account controller has made the required filings with the CFTC and NFA;
5. If any customer is operating a commodity pool but claims to be exempt from registration as a CPO, the Member should verify that the customer has made the required filings with the CFTC and NFA;
6. Members should ensure that their branch offices are not separately incorporated entities. The CFTC Division of Trading and Markets has issued an interpretive letter stating that branch offices which are separately incorporated entities are required to be registered as introducing brokers; and
7. FCM Members should determine whether non-Member foreign brokers for whom the Member carries accounts solicit U.S. customers for transactions on U.S. exchanges.

As mentioned above, these suggested steps do not purport to be a dispositive list of internal procedures required to prevent violation of NFA Bylaw 1101. Though under some circumstances a Member following these suggestions could still be found liable for a violation of NFA Bylaw 1101, the suggested procedures should help foster compliance with NFA Bylaw 1101 and greater protection to the investing public.