AMERICAN ARBITRATION ASSOCIATION

Commercial Arbitration Tribunal

In the Matter of Arbitration Between: **OSCAR D. WILLIAMS,** **Claimant,** **vs.** **MONTECITO CAPITAL MANAGEMENT, LLC,** **Respondent.**	)	**Case No. 79 516 00111 12**

FINAL ARBITRATION AWARD

THE UNDERSIGNED ARBITRATOR, having been duly appointed pursuant to the parties' agreement, dated September 18, 2007, and having been sworn and having duly heard the proofs and allegations of the parties, does hereby AWARD, as follows:

1. The parties' arbitration agreement is contained in paragraph 13 of the Investment Policy Agreement dated September 18, 2007. As provided in the Investment Policy Agreement, and confirmed by the parties at a preliminary hearing, the substantive law of California governs in this arbitration. The applicable procedural rules are the Commercial Arbitration Rules and the Supplemental Procedures for Consumer-Related Disputes of the American Arbitration Association ("AAA").

2. The arbitrator finds in favor of Claimant and against Respondent on Claimant's claims for breach of fiduciary duty, negligent misrepresentation and negligence. The arbitrator finds in favor of Respondent on Claimant's claims for intentional misrepresentation and breach of contract.

3. Respondent shall pay to Claimant compensatory damages in the amount of $631,745, and interest on such damages pursuant to Commercial Rule R-47(d)(i) at a rate of 10% per annum from January 1, 2011 through the date of this award in the amount of $263,602.04.

4. Both parties have requested an award of attorneys' fees and costs incurred in this arbitration. Claimant is the prevailing party and, puursuant to AAA Commercial Rule R-47(d)(ii), Respondent shall pay to Claimant attorneys' fees in the amount of $246,598, and costs in the amount of $40,221.

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5. The administrative fees and expenses of the AAA totaling $12,450 and the fees and expenses of the arbitrator totaling $48,474.95 shall be borne by Respondent. Accordingly, Respondent shall reimburse Claimant the amount of $36,802.50.

6. No punitive damages or forfeiture of investment advisory fees is awarded.

7. The total amount awarded in favor of claimant and against Respondent is $1,218,968.54.

8. This Award is intended to decide all claims, defenses and issues submitted by the parties for decision.

9. Any claim, defense or contention not mentioned herein is denied.

10. The arbitrator's reasons for this Award are set forth in the Statement of Reasons below.

STATEMENT OF REASONS

I. FACTUAL BACKGROUND

Respondent Montecito Capital Management, LLC ("MCM" or "Respondent") is an investment adviser registered with the State of California and based in Santa Barbara. MCM is wholly-owned and operated by Kipley J. Lytel ("Lytel").

Lytel and Oscar Williams ("Williams" or "Claimant") were friends for many years. In 2007, Williams inherited approximately $5.5 million from his father. The inheritance was distributed in stages during 2007 and 2008, and the assets were placed in The Oscar D. Williams Separate Property Trust (the "Trust"). Williams is the life income beneficiary and sole trustee, and Williams' minor son, Wyatt, is the ultimate beneficiary of the Trust.

Lytel and Williams had discussions about investment of the inherited funds, and in September 2007 MCM became investment adviser to the Trust, pursuant to an Investment Policy Agreement (the "Agreement"). Ex. 5.[1] Based upon discussions with Williams and an investment questionnaire filled out by him (Ex. 3), Lytel concluded that Williams had a moderate risk profile with equally-weighted objectives of capital preservation, income and growth.

The Trust's assets were placed in an account at Charles Schwab & Co. MCM, as a non-discretionary investment adviser, would recommend investments, but investments could only be made with Williams' approval, as Trustee of the Trust.

At the outset of the advisory relationship, MCM recommended investments in certain hedge funds. Williams had some prior experience with stock market investments, but no experience with hedge funds. Williams followed MCM's hedge fund recommendations. In the fall of 2007 the Trust invested $250,000 in Diversified SBIC Partners LP ("SBIC") and $250,000 in Think Strategies Multi-Strategies fund ("Think Strategy").

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[1] Claimants' Exhibits are identified by Arabic numbers and Respondent's by capital letters.

In 2008, after Williams received additional distributions from his father's estate, MCM recommended investments in an additional hedge fund—Alpha Titans. In 2008 the Trust invested a total of $650,000 in two Alpha Titans funds. In 2008 Lytel started his own hedge fund, Montecito Hedged Strategies Fund ("MHSF"), managed by Lytel through a Lytel-owned entity, Montecito Capital Partners ("MCP"). At MCM's recommendation, the Trust invested a total of $875,000 in MHSF, the last being an investment of $175,000 in January 2009. Lytel consulted with Williams before each of these investments, and Williams approved them.[2]

In total, the Trust invested $2,453,876 in the hedge funds recommended by MCM. The hedge funds turned out to be losing investments. With the possible exception of Alpha Titans, each of funds and their subfunds ultimately went out of business. Williams incurred out-of-pocket losses of approximately $1,263,489.78, net of distributions.

In January 2011 Williams terminated MCM's services as an investment adviser and this arbitration ensued.

II. PROCEDURAL HISTORY

This arbitration was filed on or about September 12, 2012, and the undersigned arbitrator was appointed as the sole neutral arbitrator.

On or about May 31, 2013, Claimant served a detailed statement of clams, and MCM filed a responsive pleading on or about June 20, 2013. Claimant alleged claims against MCM for breach of fiduciary duty, intentional and negligent misrepresentations, breach of contract, and negligence. All of the claims were alleged by Williams as trustee of the Trust.

The parties exchanged relevant documents and each filed pre-hearing briefs setting forth their contentions and legal authorities.

A merits hearing was held on August 26 and 27, 2014, at the offices of the AAA in Los Angeles, California. After the August 27 session, at the request of Respondent and with the consent of Claimant, the hearing was continued due to an illness in the family of Respondent's counsel. The hearing was resumed on January 27, 28 and 29, 2015. At the hearing, Lytel, Williams and William Bekkers testified. In addition, two expert witnesses testified—Craig McCann for Claimant and Yvonne Yiu for Respondent. Extensive documentary evidence was introduced.

At the conclusion of the January 29 session, both parties confirmed that they had introduced all evidence they wished to introduce. The parties and the arbitrator agreed that the parties would serve post-hearing memoranda by February 16, 2015, at which time the hearing

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[2] Under a special power of attorney, MCM had discretionary authority to trade securities in the Schwab account but could not withdraw funds from that account. However, the parties agree that the Trust's hedge fund investments were non-discretionary and made only with Williams approval. Lytel's non-hedge fund trading in the Schwab account is not involved in this arbitration.

would be closed. The post-hearing memoranda were submitted and considered by the arbitrator.[3] The hearing was closed on February 18, 2015.

Throughout these proceedings, David Hirschberg, Esq., represented Claimant and Dennis G. Merenbach, Esq., represented Respondent. The parties requested that the arbitrator issue a reasoned award.

III. THE CLAIMS AND DEFENSES

A. Breach of Fiduciary Duty

1. Applicable Legal Standard

Under California law, MCM, as an investment adviser, owed fiduciary duties to the Trust. *Twomey v. Mitchum, Jones & Templeton, Inc.*., 262 Cal. App. 2d 690 (1968); *Duffy v. Cavalier*, 215 Cal. App. 3d 1517 (1989). As the Court stated in *Oravecz v. New York Life Insurance Co.*, 174 Cal. App. 4th 1114 (2009):

> "It is well-established in this state that the relationship between a stockbroker or investment adviser and his/her customer is fiduciary in nature, imposing on the former the duty to act in the highest good faith toward the customer"

The precise scope of an investment adviser's fiduciary duty depends on "the specific circumstances presented in a given case.," *Oravecz, supra* at 1123. Based upon the applicable California authorities, MCM's duty included the duty to ascertain the Trust's financial condition and risk tolerance, to recommend only investments that were suitable for the Trust in light of its financial situation and needs, to make full and complete disclosure of investment risks, to diligently investigate and become knowledgeable about the recommended investments, and to diligently monitor the investments after they are made. *Twomey, supra* at 718-720; *Duffy, supra* at 1532-33; *Oravecz, supra* at 1123; *See also* FINRA Rule 2111; CFA Standards of Practice re Suitability (Ex. 57).

2. MCM Recommended Unsuitable Hedge Fund Investments

Based upon all of the evidence and as explained further below, the arbitrator finds that MCM breached its fiduciary duty to the Trust by recommending hedge fund investments in dollar amounts that were unsuitable for the Trust, given its assets, financial condition, purpose and investment profile.

A first duty of an investment adviser is to ascertain the client's investment profile. Here, MCM did gather information and ascertain the investment profile of the Trust. MCM learned about Williams' $5.5 million inheritance, that it was being placed in the Trust, and that Williams was trustee and life income beneficiary of the Trust, with his minor son, Wyatt, the ultimate beneficiary. MCM also learned that Williams was the life income beneficiary of two other trusts

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[3] With his post-hearing brief, Claimant submitted a letter objecting to the introduction in evidence of Respondent's Tab P. This objection is overruled.

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being managed by Citibank. Wyatt was also the ultimate beneficiary of these trusts. There was about $2 million in the Citibank accounts. They generated approximately $48,000 in annual income. Williams was unemployed, and prior to the 2007 inheritance the trust income from the Citibank accounts was Williams' only income.[4]

Based upon discussions with Williams and his investment questionnaire, MCM prepared an Investment Policy Statement in September 2007 (Tab C, Ex. 5), concluding that the Trust had a "moderate risk tolerance," with equal objectives of capital preservation, income and growth. In email correspondence, Williams emphasized the importance of preservation of capital for the benefit of his son. Ex.6, 00040, 53. Williams also indicated he needed income of $125,000 from the MCM-managed assets (Ex. 6, 000111)[5] and that he wanted "growth" to keep up with inflation Ex. 6, 000040. Williams agreed with MCM's investment policy statement.

The hedge funds recommended by MCM to Williams were not suitable in light of the Trust's investment profile in the dollar amounts recommended.[6] The fact that the investments were for the Trust, and not Williams individually, is relevant to the suitability of the investments, in that MCM knew that Williams had fiduciary duties to the ultimate beneficiary, his son, to take prudent steps to preserve assets for the son, as the ultimate beneficiary of the Trust

As Claimant's expert McCann testified, and as various offering documents for the hedge funds state, hedge funds are speculative, high risk investments. Hedge funds are not an "asset class" (like stock or bonds). Rather they are pools of investors' money invested by fund managers in wide variety of investment styles and techniques. As such their success depends, critically, on the skill (or luck) of the individual manager. The ability to *evaluate* a manager is extremely difficult, however, because the funds do not publish reports showing the actual investments made with fund assets. Not only that, there is no standard of reporting for private hedge funds, but rather a considerable degree of reporting "discretion" or "self-reporting" by fund managers. The assets of hedge funds, many of which are illiquid and not freely tradeable, are valued by the managers themselves for financial reporting purposes.[7] Not surprisingly, as Lytel acknowledged in a January 2009 email to Williams, "fraud has been an issues in the [hedge fund] industry." Ex. 6 0000104

Lytel claims to have "vetted" the funds he recommended by interviews with fund managers, administrators, investors, lenders, and auditors. The evidence was sketchy, however, as to what information Lytel was able to discover from this "due diligence." Fund managers are apparently willing to generally describe their investment approach (e.g., long-short, market neutral, multi-strategy, arbitrage, special situations), but these labels tell little about how an individual fund actually works. And the funds' historical results are no great assurance, because "past results are not guarantee of future performance" and because fund managers have unfettered discretion to *change* their investment policies or strategies over time, without

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4 Williams was a writer and had been working for some years on a book, but had not yet found a publisher.

5 Claimant's expert testified that the $125,000 amount was after tax, but Williams testified it was a before-tax number.

6 The amounts of Trust assets invested in the hedge funds is further discussed in Parts III(A)(4) and IV(A) below.

7 The funds recommended by MCM were "private" hedge funds, and thus did not have the protections in financial reporting or otherwise than an SEC-registered fund would have.

disclosing that to outsiders. A given fund's "track record" is also unreliable because the investor (or investment adviser) simply does not know how the past returns were achieved.

There are additional characteristics of hedge funds that, in the arbitrator's view, make them highly risky: illiquidity, leverage and high fees. Hedge funds can be highly illiquid in at least two senses: they do not pay regular income to investors and investors may not be able to withdraw monies from the funds (unlike, say, a mutual fund). High leverage is common, which increases potential for high returns, but also high losses. And fees charged by hedge fund managers are high, ranging from 1-3% of assets, plus incentive bonuses ranging from 12-30% of profits. Hedge fund managers are incentivized to take risks to achieve high returns, because their investors' returns net of fees will be small unless they make high profits.

The hedge funds recommended by MCM were "funds of funds," i.e., hedge funds that do not make direct investments, but rather invest in multiple, separately managed subfunds, which make the actual investments. Although funds of funds have been said to reduce risk by spreading investment dollars among multiple funds with different investment strategies, there are other downsides to these funds. They place critical importance on the ability of the managers to select the subfunds, a difficult task at best. Moreover, an investor or investment adviser likely will have little or no access to the managers of the subfunds. The leverage and liquidity problems can be magnified, because leverage may exist at both the fund of funds and subfund levels, and individual subfunds may not permit withdrawals of monies, no matter what the policy of the fund of funds may be for withdrawals. Similarly, the high hedge fund fees are magnified, because they are charged at both the fund of funds and hedge funds levels, including both management fees and incentive bonuses. Respondent's expert, Yvonne Yiu, agreed with the Bernstein article cited by Claimant's expert, that "the risk/reward profile is least attractive for funds of funds; with their two layers of fees their upside is limited and their results are heavily skewed to the downside."[8]

Other disadvantages of hedge funds are their tax inefficiency and the greater degree of risk from newly-formed hedge funds or those without a lengthy and profitable history. Finally, because hedge funds are designed to achieve returns from techniques separate from traditional stock market investing, their losses can be *permanent*, unlike stock or bond investments, which can decline in value and then recover over time.[9]

Essentially *all* of the risks and problems described above were experienced by the funds recommended by MCM to the Trust, and resulted in the Trust's investment losses. For example:

- **SBIC.** SBIC, was a relatively new fund of funds, founded in 2004. Although it had a predecessor fund that had been successful, SBIC was to be different, using substantial leverage at the fund of funds level, through a French bank, Societe Generale. Due to a complex "warrant structure," it was highly illiquid. There were high fees at both fund levels, as well as a 10.5% of net asset value "financing and administration charge." According to its manager,

[8] Bernstein, "*Hedge Funds—Too Much of a Good Thing?* McCann Report, Tab C, at 20.

[9] Bernstein, *supra*, at 11.

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William Beckers, there were some 44 subfunds, each with its own manager (and fee structure).[10] In the 2005-2007 period, it reported earnings as high as 37%, requiring earning before fees of as high as 50% of assets. Such profits could only have been achieved by taking high risks. In 2008, about one year after the Trust's investment, the fund failed when Societe Generale "foreclosed" on its loans, putting the subfunds and SBIC out of business. Ex. 6, 000128. The Trust's $250,000 investment was lost.

- **Think Strategy**. The Trust invested a total of $650,000 in two Think Strategy fund of funds—Class A and Class B. Founded in 2003, the Think Strategy funds were advertised as "market neutral," designed to produce "stable absolute returns throughout the economic cycle, with low correlation to the performance of equity and fixed income markets." Ex. 20 at 000521. Think Strategy claimed to select subfunds that "have proven positive returns in both up and down economic cycles," *Id.* at 000524, and that "Capital preservation and risk control are central to all investment activities." *Id.* at 000521. In its 2008 "Confidential Information Memorandum," the fund stated under "Investor Suitability" that it was open only to "Professional Investors" or persons who consented to be treated as a professional investor.[11] The Memorandum describes in general terms various "strategies" that funds might employ, but makes clear that there were no limits on such strategies, which could change over time. Ex. 26.

Williams attempted to redeem the Trust's investment in Think Strategy in January 2010, but was never able to do so. Ex. 6, 000112. During 2010, Lytel reassured Williams on the safety of this investment and the forthcoming redemption. Presumably, these assurances were based on reports generated by Think Strategy. In fact, the funds failed and the Trust's entire $650,000 investment was lost. In 2011 the SEC sued Think Strategy's managers, alleged that they misstated the due diligence checks on certain subfund managers selected for inclusion in its fund of funds portfolio, resulting in investments in funds that were revealed to be Ponzi schemes. Ex. 26.[12]

- **Alpha Titans.** Alpha Titans were fund of funds, both leveraged and unleveraged, that were started in November 2007. In 2008 the Trust invested a total of $650,000 in two of these funds—Class 1X and MultiStrategy Class 1.5X. The funds were tax inefficient and, like other funds of funds, had management and incentive fees at two levels. The Trust was able to redeem its investment in the leveraged Alpha Titan fund by the end of 2008 at a loss of $73,000, and in 2010 and 2011 redeemed the unleveraged fund, achieving a return of its invested capital. McCann Report, Ex. 3 at pp. 3-4. , Alpha Titans was the best-performing of the hedge funds recommended by MCM.

- **MHSF.** Lytel recommended that the Trust invest in MHSF, his own fund of funds, commencing in late 2007, prior to formation of the fund. Ex. 6, 00053. Beginning in May 2008 and extending through January 2009, the Trust invested a total of $875,000 in this new hedge fund, managed by Lytel through MCP. MCM's promotional materials (Ex. 8) stated

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[10] When asked if the subfunds used leverage, William Bekkers, SBIC's manager, testified he did not know, because he "did not know how they ran their business."

[11] The evidence was unclear whether Williams ever signed such a consent.

[12] Williams first learned of the demise of Think Strategy when he got a call from a U.S. Attorney who was investigating the funds. Ex.6, 000141.

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that its subfunds had "a history of positive performance in down markets," that "the Fund's approach is designed to provide steady, consistent returns while protecting against significant losses under all financial market conditions," and represented "Profitable history in all markets – capital preservation." Lytel emailed Williams in December 2007 that "This fund has less risk than the other fund of hedge funds we work with –the impetus for the new release." Ex 6, 000052[13] Williams responded that "a position in the Hedge Fund would be a good thing since preserving assets is a key goal of the trust." *Id.*, 000053.

MCM, as a fee-based investment adviser, emphasized that it was free of conflicts of interest and contrasted its business model with commission-based advisers, stating:

> "We believe that accepting commissions is inherently unprofessional since it impairs an advisor's objectivity. We believe our compensation should come from the party to whom we owe our loyalty—the client.
>
> This removes virtually all remaining potential conflicts of interest; in the fee-only community, it is known as being 'pure.' This ensures that we do not have a financial incentive to take an inordinate amount of risk with your portfolio in pursuit of unnecessarily high returns."

Ex. 7, 000164. In forming MHSF and recommending it to the Trust, MCM departed from this "pure" model, and had a clear conflict of interest. As general partner of MHSF the Lytel entity MCP was to receive a management fee of 1.25% and a performance fee of 12.5% of profits. These fees were in additional to investment adviser fees charged to the Trust under the Agreement. Thus, MCM had a financial incentive to recommend that the Trust invest in MHSF over other potential hedge fund investments. MCP also had an incentive to take risks in the management of MHSF to achieve high returns—and thus high incentive fees.

The arbitrator does not believe that under California law it is per se unlawful for an investment adviser to recommend a fund that he controls. However, as a fiduciary to the Trust, MCM had a clear duty to make a full, accurate and understandable disclosure of all facts bearing on MCM's conflict of interest respecting MSHF. Ex. 57, CFA Standards of Practice Handbook at 001121.

Although the evidence conflicted on this point, the arbitrator finds that in certain respects MCM failed to make adequate disclosures respecting these conflicts. Although the fund was new, MHSF used a "pro forma" set of financial results going back to 2001, prior to the commencement of MCM's business and long before formation of MHSF. MCM did not adequately explain the nature of these performance figures, which were apparently based, at least in part, on performances of hedge funds that MCM had recommended to two of his clients. The written presentation of these results do not make that clear. MCM also emphasized the importance of hedge fund managers having their own money invested in the fund, without disclosing to Williams that MCM and Lytel had no money invested in MHSF. Most

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[13] An MCM document about hedge fund investeing acknowledges many hedge fund risks (Ex. 7, 000163) but claims the ability to "mitigate" those risks (000164)

significantly, however, there is no indication that MCM clearly disclosed to Williams that there *was* a conflict of interest that could affect MCM's recommendation of MHSF and that Williams should obtain an independent evaluation of this fund.

Lytel advised Williams of "reporting problems" with at least one of MHSF's subfunds as early as 2009. Ex. 6 000106. In January 2011, when Williams terminated MCM's services, he requested redemption of the Trust's MHSF investment. In May 2011, Lytel advised investors that MHSF had suspended redemptions (as had its subfunds), there were subfund "reporting problems" and the MHSF would be liquidated. Exs. 15, 16. The Trust did, however, receive a substantial distribution of 450,000 in April 2011, reducing its ultimate losses on this investment to approximately $303,000.

3. Respondent's Defenses

Respondent makes a number of arguments that the hedge fund investments recommended by MCM were suitable for the Trust.

First, Respondent's expert witness, Yvonne Yiu, testified that the recommended hedge funds were suitable for an investor with the Trust's investment profile. While Ms. Yiu was a qualified expert witness, the arbitrator believes that Mr. McCann's expert testimony, combined with the factual evidence about hedge funds in general and the recommended funds of funds, is more persuasive on this issue.

Respondent also places great weight on the fact that MCM's hedge fund recommendations were on a "non-discretionary" platform, under which Williams had the final say on whether to invest. The arbitrator believes this argument misses the point. As an investment adviser and fiduciary, MCM had a duty to *recommend* suitable investments, and Williams was entitled to, and in the arbitrator's view did, rely on those recommendations. The adviser owes such a duty for both discretionary and non-discretionary accounts. *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d at 717 (1968)(broker committed breach of fiduciary duty and negligence, even though he obtained telephonic approval from client before making each trade); *Oravecz v. New York life Ins.*, 174 Cal. App. 4th 1114, 1122-23 (2009)(fiduciary duty under California law not limited to discretionary accounts).

Respondent makes a similar argument that Williams was a "sophisticated" investor who made his own decisions without relying on MCM. Respondent's expert Yiu pointed to the definition of sophisticated investors for securities law private offering purposes, based on the net worth of the investor. The arbitrator believes that this definition, while applicable in establishing certain securities law exemptions from registration, is not applicable to the fiduciary relationship between an investment adviser and client. Moreover, the California courts have rejected arguments that investment advisers may avoid liability based on the "sophistication" of the adviser's client. *Duffy v. Cavalier*, 215 Cal. App. 3d 1517.

In *Duffy* the defendant argued that a broker owes no fiduciary duty to a "sophisticated" client unless the stockbroker "controls" the investor's account. The Court rejected this argument, stating that it was "contrary to long-established California law. 215 Cal. App. 3d at 1530. The Court also rejected the contention that the plaintiff was a "sophisticated" investor

who understood the risk of options he was investing in and "controlled" his accounts because he had sufficient intelligence, experience and understanding to evaluate the stockbroker's recommendations and reject any which were unsuitable, stating that "neither of these legal and factual premises has any merit." In *Duffy* the defendant was held liable for recommending risky stock options, notwithstanding that the client, Duffy, claimed to have some knowledge of options trading and was enthusiastic about making the investments.

Here, the arbitrator believes, and therefore finds, that the Trust invested in hedge funds at the recommendation of MCM, and not because of any independent knowledge or evaluation by Williams. Williams had some prior experience with his own stock brokerage account, but he was by no means an investment expert and had no knowledge of hedge funds or how they work. Lytel held himself out as an expert in hedge funds and admits recommending the hedge fund investments that the Trust made. Some of these recommendations were made along with assurances about their safety and benefits. In recommending Alpha Titans in 2008 Lytel emailed Williams that "I am trying to position you for neutral/absolute returns that after 1-2 years you will find that regardless of what happens to the markets, you should either not be losing money (then markets tank) or making a greater return than the market (S&P)." Ex. 6, 000071. In suggesting a $500,000 investment in MHSF in 2008 Lytel told Williams it was a "good time for 'certain' hedge fund investments . .the current pricing inefficiency and anomalies should yield stellar results down the road." Ex. 6, 000055. The arbitrator believes, and therefore finds, that Williams invested trust assets in hedge funds in reliance on MCM's recommendations.

Respondent also contends that MCM should be free of liability because the riskiness of the hedge fund investments was disclosed by Lytel to Williams and also disclosed in the private placement memoranda for these private funds. As to direct oral disclosures by Lytel to Williams, the arbitrator finds, based on conflicting evidence, that MCM disclosed that hedge had certain risks, but gave assurances that MCM could take measure to mitigate those risks to make them suitable for the Trust's investment profile. Similarly, MCM's own documents mention some risks, but also claim that hedge funds, including MHSF, were *protections* against risks such as a down stock market.

The various PPMs are lengthy legal documents that are difficult for a layman such as Williams to understand. The do make various disclaimers and risk disclosures to the effect that "you could lose all your money" and "you must be prepared to do so." If these disclosures are taken literally, no one except a confirmed gambler would invest.[14] The language appears to be an effort by the issuer of the units (the funds) to limit their liability. Whatever their effect may be on such liability, the arbitrator does not believe they exculpate an independent investment adviser from liability for recommending unsuitable investments. Some of the PPMs instruct the investor to consult with independent advisers about suitability of the investment. Ex. 19, 00000442 ("investors should consult with their independent advisers . . . as to suitability of the investment"). That is what Williams did, and he was entitled to rely on advice provided by MCM. See *Blankenheim v. E.F. Hutton & Co.*, 217 Cal. App. 3d 1463 (1990)(rejecting

[14] Yiu testified that "you could lose your entire investment" disclosure is made with respect to all types of investments, including conservative investments. Thus, such statements are not informative on the risk of the particular investment.

argument that risk disclosures in private placement memoranda made investor's reliance on investment adviser's recommendations unjustifiable as a matter of law).

Similarly, the fact that Williams participated in certain conference calls with fund managers and spoke directly with William Bekkers, the manager of SBIC, does not eliminate MCM's responsibility. There was little evidence what was actually said in these calls, and these calls may have been marketing conversations by hedge fund managers, rather than "due diligence" calls by Williams.

Finally, Respondent contends that the trust suffered investment losses because of the stock market collapse of 2008-2009, and not because of any unsuitable recommendations by MCM. Although the financial crisis of 2008 and resulting stock market decline are well known, the evidence in this case did not show what caused the collapse of the hedge fund recommended by MCM. This is not surprising, because the hedge funds, and particularly the subfunds who made the actual investments, did not disclose what their investments were, much less what caused them to fail. Nor does the evidence show the extent of the leverage incurred by those funds.

It is also somewhat ironic to contend that the stock market decline brought about the hedge fund failures, because the funds were advertised as "market neutral" with little "correlation" to what the stock market did. See, e.g., Ex. 6, 000044 (MCM recommends "long-short" funds with little correlation to the markets. And expert witness Yiu testified that in 2008-2009 hedge funds outperformed the market as a whole. Thus, the arbitrator cannot conclude that the Trust losses were caused by unforeseen and severe market conditions in 2008 and 2009.

4. <u>The Amounts of the Trust's Hedge Fund Investments Were Excessive</u>

As explained above, the arbitrator believes that the hedge fund investments recommended by MCM were speculative, high risk investments. However, as Respondent and its expert points out, even a "moderate risk tolerance" portfolio may have a portion of the portfolio devoted to higher risk investments without departing, overall, from the risk profile. Hedge funds were, and are, a recognized form of investment vehicle. Accordingly, the arbitrator does not find that hedge fund were *per se* unsuitable for the Trust's portfolio. Rather, the arbitrator finds that the *amount* of Trust assets invested in hedge funds on MCM's recommendations was excessive and unsuitable for the Trust.

The evidence established the total dollar amount of the Trust's hedge fund investments--$2,453,876. Ex. 41. There was evidence—including Williams' testimony—that Williams inherited approximately $5.5 million from his father which was subject to MCM's investment advice, and that there was an additional $2 million in the Citibank trust accounts from which Williams received income. Using these figures, Respondent contends that the Trust's hedge fund investments represented about 32% of the total assets.[15]

[15] Although the Citibank accounts had independent trustees and were not managed by MCM or Williams, the arbitrator agrees with Respondent that the $2 million at Citibank could be taken into account for purposes of making Trust investment recommendations and decisions.

McCann, on the other hand, calculated that the hedge fund investments represented about 39% of the total assets, using a $6.2 million total asset figure. Ex. 41, at 26. There was some basis in the evidence for reducing the total asset figure from the $7.5 million amount. For example, MCM's invoices for adviser fees reflected the total "assets under management," but the highest amount shown on those invoices was about $4.3 million, not $5.5 million. Ex. 22, 000578.

The arbitrator accepts the 32% percentage figure, and finds that, given the Trust's moderate risk tolerance, the total amounts invested in hedge funds was excessive and unsuitable for the Trust. The arbitrator further finds that investing approximately one-half that percentage, or 16% of Trust assets in hedge funds would have been a suitable amount. See Bernstein at 22-23; McCann testimony. In calculating the Trust's damages, the arbitrator has awarded damages based on this finding that one-half of the monies invested in hedge fund was excessive, and therefore that Claimant's total damages should be reduced by one-half. See Part IV(A) below.

5. <u>Other Causes of Action.</u>

In addition to the breach of fiduciary claim, Claimant asserted causes of action for intentional fraud, negligent misrepresentation, negligence and breach of contract.

For the reasons set forth above, the arbitrator finds in favor of Claimant and against Respondent on the claims for negligent misrepresentation and negligence. The evidence does not, in the arbitrator's view, establish that MCM made intentionally false representations to Claimant and finds in favor of MCM on the intentional fraud claim. The evidence also failed to show breaches of the terms of the Agreement, and the arbitrator finds in favor of MCM on the breach of contract claim.

IV. <u>MONETARY RELIEF</u>

A. Compensatory Damages

Claimant's calculation of damages in the amount of $1,263,490 (Ex. 41, p. 28) is consistent with California law. *Twomey v. Mitchum Jones & Templeton*, 262 Cal. App. 2d 690 (1968). This calculation represents the Trust's out-of-pocket losses (amounts invested less amounts of distributions obtained from hedge funds).

Claimant's damages calculation will be adjusted, however, to take into account the arbitrator's finding that while some investment of Trust assets in hedge funds was suitable, an excessive amount was so invested. The award reduces the damages amount of $1,263,490 by one-half, or 50%, resulting in a damages award of $631,745.

B.` Pre-Award Interest

AAA Commercial Rule R-47(d)(i), applicable in this case, provides that an award may include "interest at such rate and from such date as the arbitrator(s) may deem appropriate." In this case the arbitrator awards pre-award interest at a rate of 10% per annum from January 1, 2011 through the date of this award in the amount of $263,602.04.

C. Attorneys' Fees and Costs

AAA Commercial Rule R-47(d)(ii) provides that attorneys' fees may be awarded if all parties have requested such an award or it is authorized by law or their arbitration agreement. Here, both parties have requested an award of attorneys' fee and costs. Claimant's Post-Hearing Brief at 13; Respondent's Closing Brief at 15 and Ex. A-2. Accordingly, Claimant, as the prevailing party, is entitled to recover his attorneys' fees in the amount of $246,598, and costs in the amount of $40,221, as well as the amount Claimant has advanced for AAA administrative fees and expenses and arbitrator's fees.

DATED: March 4, 2015

Richard R. Mainland, Esq.
Arbitrator