SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES ACT OF 1933
Rel. No. 8437 / July 7, 2004

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 49979 / July 7, 2004

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 2258 / July 7, 2004

Admin. Proc. File No. 3-9784-EAJA

In the Matter of

MICHAEL FLANAGAN, RONALD KINDSCHI, AND SPECTRUM ADMINISTRATION, INC.
c/o Kutak Rock LLP
225 Peachtree Street, N.E.
Suite 2100
Atlanta, GA 30303-1731

OPINION OF THE COMMISSION

EQUAL ACCESS TO JUSTICE ACT PROCEEDINGS

Applicants, who had prevailed in Commission broker-dealer and investment adviser proceedings, sought an award of fees and expenses under the Equal Access to Justice Act. Held, the application is denied because the Division of Enforcement's position in the underlying action was substantially justified.

APPEARANCES:

Michael K. Wolensky, of Kutak Rock LLP, for Michael Flanagan, Ronald Kindschi, and Spectrum Administration, Inc.

William P. Hicks and William S. Dixon, for the Division of Enforcement.

Appeal filed: December 17, 2003
Last brief received: March 8, 2004

I.

Michael Flanagan, Ronald Kindschi, and Spectrum Administration, Inc. ("Applicants") appeal from the decision of an administrative law judge (the "EAJA Decision"), 1/ denying their application for attorneys' fees and other expenses under Section 504 of the Equal Access to Justice Act ("EAJA"). 2/ Flanagan and Kindschi, registered representatives with FSC Securities Corporation ("FSC"), a registered broker-dealer, were charged with violations of Section 17(a) of the Securities Act of 1933, 3/ Section 10(b) of the Securities Exchange Act of 1934, 4/ and Exchange Act Rule 10b-5. 5/ Spectrum Administration, Inc. ("Spectrum"), a registered investment adviser with which Kindschi was associated, was charged with violations of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, 6/ and Kindschi, in his role as an associated person of Spectrum, was charged with aiding and abetting Spectrum's alleged violations.

The Order Instituting Proceedings ("OIP") in the underlying proceeding alleged that Applicants committed fraud by steering certain customers to purchase Class B shares of various mutual funds without disclosing all material facts regarding the costs associated with those purchases. In his initial decision in the underlying proceeding (the "Initial Decision"), 7/ the law judge found that, while not all of the Division's charges had been proven, Applicants had committed violations of each of the statutes or rules indicated above. Applicants appealed the findings of violation; the Division did not appeal the charges dismissed, although it did apply for review, seeking increased sanctions for the violations found in the Initial Decision. We dismissed the proceeding, finding that the

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1/ Michael Flanagan, Ronald Kindschi, and Spectrum Administration, Inc., Initial Decision Rel. No. 241 (Nov. 24, 2003), 81 SEC Docket 2940.

2/ 5 U.S.C. § 504.

3/ 15 U.S.C. § 77q(a).

4/ 15 U.S.C. § 78j(b).

5/ 17 C.F.R. § 240.10b-5.

6/ 15 U.S.C. § 80b-6(1) and (2).

7/ Michael Flanagan, Ronald Kindschi, and Spectrum Administration, Inc., Initial Decision Rel. No. 160 (Jan. 31, 2000), 71 SEC Docket 1709.

evidence presented in the record did not support a finding of liability on the charges before us. 8/

This EAJA claim ensued. The EAJA provides that applicants who have prevailed against the government in an adversary proceeding may recover the fees and expenses incurred unless "the position of the agency was substantially justified." 9/ The law judge, in his initial EAJA decision, found that the Commission's case against Applicants, on the whole, was substantially justified and denied Applicants payment of the fees and expenses for which they applied. 10/ Applicants contend on appeal that the Division's position was not substantially justified and that they are entitled to fees and expenses under the EAJA. We base our findings on an independent review of the record.

8/ Michael Flanagan, Ronald Kindschi, and Spectrum Administration, Inc., Exchange Act Rel. No. 48255, Investment Advisers Act Rel. No. IA-2152 (July 30, 2003), 81 SEC Docket 2766.

9/ 5 U.S.C. § 504(a)(1).

10/ Applicants have submitted sworn affidavits from their attorneys and itemized invoices of their legal fees, uncontested by the Division, which indicate that Applicants incurred $352,521.81 in attorneys' fees and legal expenses in connection with this matter. Applicants argue that, if they do not receive payment for their expenses at the actual billing rate that they paid, under the EAJA, they should be compensated at the rate of $125.00 per hour. At this hourly rate, their fees and expenses total $243,010.78.

II.

Spectrum provides asset allocation and investment advice to clients wishing to diversify substantial assets among mutual funds. As part of this advice, Spectrum obtains market-timing signals for certain of its clients from Spectrum Financial, Inc., a Virginia-based investment adviser. Spectrum Financial developed several different mathematical models to time the purchase, sale, and exchange of mutual fund shares.

Kindschi recommended to his client, the retirement plan of the Long Beach Plywood Company (the "Plan"), that it employ a market-timing strategy. Kindschi testified that he recommended Class B shares of the Putnam High Yield Trust Fund, based upon his belief that Class B shares could be used reliably to employ a market-timing strategy. 11/ Kindschi testified that he based this belief in part on his previous success in convincing funds to waive the contingent deferred sales charge when clients were forced to leave a fund because the fund no longer permitted them to employ a market-timing strategy. The Plan's trustee, Philip A. Wiedrick, Jr. testified that, based upon Kindschi's recommendation, he chose to invest $285,000 of the Plan's money in Class B shares of this Putnam fund.

The prospectus for the fund detailed the availability of reduced initial sales charges for purchases of Class A shares, in a series of breakpoints, as the size of the investment increased. One such breakpoint occurred when a customer invested $250,000. The prospectus also stated that "[o]rders for Class B shares for $250,000 or more will be treated as orders for Class A shares or declined." The Plan's investment was split into two purchases, one

11/ Typically, Class A mutual fund shares differ from Class B mutual fund shares with respect to initial sales charge, expense ratio, contingent deferred sales charge, and commissions, among other things. Class A shares typically include an initial sales charge, but Class B shares do not. The expense ratios for Class B shares generally are higher than the expense ratios for Class A shares. Class B shares typically include a contingent deferred sales charge, and Class A shares typically do not. The contingent deferred sales charge normally declines the longer an investor holds the shares and typically is eliminated after six to eight years, at which point Class B shares sometimes may be converted to Class A shares. In addition, Class A shares, unlike Class B shares, entail a declining rate of commission to the broker at breakpoints.

purchase for $249,999.99 and the other for the remaining amount. Kindschi received a greater amount in commissions than he would have received had the Plan invested in Class A shares.

Flanagan's customer, John Holloway ("Holloway"), also used Spectrum Financial's timing strategies for three different investment accounts over which he exercised decision-making authority. The record also indicates that three other accounts related to Holloway's family employed the market-timing strategy. Based upon Flanagan's recommendation, Holloway decided to invest $250,000 in Class B shares of Putnam's Municipal Income Fund for one of these accounts. This Putnam fund, like the Putnam High Yield Trust Fund used by the Plan, limited the amount that could be invested at one time in Class B shares to under $250,000 and provided breakpoint discounts when a customer invested $250,000 or more. Holloway's $250,000 investment was split into two purchases.

Based upon Flanagan's recommendation, Holloway also used Spectrum Financial's market-timing strategy for three other Holloway family accounts under his control and invested in Class B shares of mutual funds various amounts that would have qualified for breakpoint discounts had Class A shares of the same fund been purchased. For all of these purchases, Flanagan received a greater amount in commissions than he would have received had Holloway invested in Class A shares.

The OIP alleged that the acts of Kindschi, Flanagan, and Spectrum described above amounted to fraud on their customers. Specifically, the OIP alleged a failure by Applicants to disclose: i) the availability of breakpoint discounts for Class A, and not Class B, mutual fund shares; ii) the fact that Class A shares generally produce materially higher returns for long-term investors than Class B shares; iii) that Applicants would receive higher commissions for the sale of Class B shares than the level of commissions they would receive for the sale of Class A shares; 12/

12/ In connection with the Plan's $249,999.99 investment in the Putnam High Yield Fund Class B shares, FSC received a commission of $10,000, or 4% of the investment. If the Plan had invested $250,000 in Class A shares of that fund instead, the commissions to FSC would have been $5,625, or 2.25% of the investment. The Class B shares had an expense ratio of 1.86%, compared to 1.09% for the Class A shares.

The various investments by the Holloway accounts in Class B

(continued...)

and iv) the possibility of structuring their clients' investments using Class A shares, in a way that would have ". . . provided the diversification the customers and clients desired; qualified such investments for breakpoints; and produced materially higher returns for long term investors than Class B shares of the same or similar, mutual funds." The OIP also alleged that Flanagan "misrepresented that customers had to purchase class B shares of particular funds in order to take advantage of the services of a particular market timing service" and "fraudulently induced one customer to switch from a mutual fund to a fund with similar objectives by misrepresenting that a particular market-timing service would not provide its services in the absence of such a switch."

In the EAJA Decision, the law judge denied the application for fees, finding that the Division's case was substantially justified. The law judge found that the entirety of the Division's case had a reasonable basis in law. The law judge also found that most of the Division's case against Applicants had a reasonable basis in fact.

The law judge specifically found, however, that four of the Division's charges did not have a reasonable basis in fact. 13/ The law judge found that the Division lacked a reasonable factual basis for: i) its fraud charges against Flanagan involving accounts controlled by Holloway's wife; ii) its charge that Flanagan had misled Holloway by telling him that it was necessary to invest in Class B shares in order to employ a market-timing strategy; iii) its charge that Flanagan had fraudulently induced one of the Holloway accounts to switch mutual funds in which it invested by misrepresenting that a market-timing service would not provide its services in the absence of that switch; and iv) its charge that Kindschi failed to inform the Plan that it could have structured its

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12/ (...continued)
shares of Putnam, Kemper, and MFS funds produced total commissions for MFS that were approximately $15,000 greater than if the investments had been made in Class A shares of the same funds. In addition, the expense ratios were always higher for the Class B shares Flanagan recommended than they would have been if the Holloway family accounts had purchased Class A shares of the same funds.

13/ These four charges were included in the charges the law judge dismissed in the Initial Decision. The law judge also made various rulings on the amount of fees that should be awarded in the event the Commission disagreed with his determination that fees were not warranted.

investments using Class A, rather than Class B, shares, accomplishing its investment goals while also benefitting from breakpoints and higher long term returns.

In making his ultimate EAJA decision, notwithstanding his finding that four Division charges lacked substantial factual justification, the law judge found that the Division's case, viewed in its entirety, had a reasonable basis in law and fact and, thus, was substantially justified. As a result, the law judge denied the application for fees under the EAJA.

III.

A. Introduction

The EAJA provides, in relevant part, that applicants who have prevailed against the government in an adversary proceeding, such as the Commission's case against Applicants, may recover fees and expenses incurred by such applicants in connection with the proceeding, "unless . . . the position of the agency was substantially justified . . . ." 14/ It is undisputed that Applicants, having won a dismissal on all charges that were litigated, prevailed in the underlying proceeding. Applicants also presented evidence credited by the law judge as establishing that they had actually incurred the expenses and fees they seek in connection with the Division's case against them, 15/ and the Division did not contest the validity of these expenses either before the law judge or on this appeal. 16/

Therefore, the question remaining under the EAJA is whether the Division's case against Applicants was "substantially justified."

14/ 5 U.S.C. § 504(a)(1). Applicants for EAJA fees must also meet certain financial criteria to be deemed eligible for fees under the Act. The parties do not dispute Applicants' eligibility here.

15/ See Kirk Montgomery, Exchange Act Rel. No. 45161 (Dec. 18, 2001), 76 SEC Docket 1394, 1412-15.

16/ The Division did contest that Applicants were eligible to receive payment for certain of the fees under the EAJA, claiming that certain expenses arose out of unauthorized filings made by Applicants' counsel or were otherwise unrelated to this proceeding.

17/ Because a different legal standard applies, the conclusions we reached in the proceeding on the merits do not determine the substantial justification question for EAJA purposes. 18/ In an EAJA proceeding, in determining whether the Division's position was substantially justified, we make an "independent evaluation" 19/ of whether the Division's case had a "reasonable basis in law and in fact." 20/ If the Division's case is "justified to a degree that could satisfy a reasonable person," 21/ then no fees are to be awarded under the EAJA.

The Supreme Court has stated that ". . . EAJA . . . favors treating a case as an inclusive whole, rather than as atomized line-items." 22/ In Jean, a determination was made that the government's position on the merits had not been substantially justified. The specific question at issue in that case was whether fees should be denied for the fee application portion of the proceedings if it was determined that the government's position on the fee application was

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17/ The burden of demonstrating substantial justification lies with the Division. 17 C.F.R. § 201.35(a).

18/ Rita C. Villa, Exchange Act Rel. No. 42502 (Mar. 8, 2000), 71 SEC Docket 2438, 2443.

19/ FEC v. Rose, 806 F.2d 1081, 1087 (D.C. Cir. 1986)(independent evaluation to be conducted "through an EAJA perspective" in order to ". . . honor Congress' intent, manifest in the inclusion of this standard, not to permit a prevailing party automatically to recover fees").

20/ Roanoke River Basin Ass'n v. Hudson, 991 F.2d 132, 139 (4th Cir. 1993), cert. denied, 510 U.S. 864 (1993)(noting the distinction between a finding that a party prevailed in the underlying proceeding and a determination as to the reasonableness of the government's position in bringing or continuing the litigation); Villa, 71 SEC Docket at 2443 (establishing reasonableness as the test of whether an agency's argument is substantially justified).

21/ Pierce v. Underwood, 487 U.S. 552, 565 (1988). See also id., n.2 (". . . a position can be justified even though it is not correct, and we believe it can be substantially (i.e., for the most part) justified if a reasonable person could think it correct, that is, if it has a reasonable basis in law and fact").

22/ Comm'r, INS v. Jean, 496 U.S. 154, 161-62 (1990).

substantially justified. The Court, in rejecting the government's request for the separate determination, reasoned broadly that, in the text of the EAJA, the fact "that the 'position' is . . . denominated in the singular . . . buttresses the conclusion that only one threshold determination for the entire civil action is to be made." 23/ We believe that this language controls our decision here. Thus, we consider whether the Division's case as a whole was substantially justified, that is, whether it had a reasonable basis in law and in fact.

B. Basis in Law

The Division's legal theory was that Applicants were required to disclose to their customers purchasing Class B shares (or the equivalent) in amounts that would qualify for breakpoint discounts the availability of such breakpoint discounts on Class A shares, regardless of any disclosures made in the prospectuses. 24/ We note that Applicants do not dispute in this EAJA appeal the legal theories argued by the Division. 25/

23/ Id. at 159. Applicants cite language from Goldhaber v. Foley, 698 F.2d 193 (3d Cir. 1983), that suggests a contrary result. Goldhaber was decided before Jean, and its continuing validity has been questioned since Jean. See, e.g. Utu Utu Gwaitu Paiute Tribe v. Dept. of Interior, 773 F.Supp. 1383, 1387 (E.D. Cal. 1991).

24/ See, e.g. Prudential Secs., Inc., Exchange Act Rel. No. 48149 (July 10, 2003), 80 SEC Docket 2164 (settled order involving violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5 for failing to disclose breakpoints and, as a result, generating increased commissions for registered representative); Russell C. Turek, Exchange Act Rel. No. 45459 (Feb. 20, 2002), 76 SEC Docket 2823 (same); Wendell D. Belden, Exchange Act Rel. No. 47859 (May 14, 2003), 80 SEC Docket 699 (sustaining NASD disciplinary action for recommendation of Class B shares and structuring transactions to avoid limits on amount of purchase of Class B shares).

25/ Instead, Applicants focus their appeal of the law judge's EAJA Decision on the facts of this case as applied to the legal arguments made by the Division.

Securities professionals "owe a special duty of fair dealing to their clients." 26/ We have held that, consistent with this duty, one who sells mutual fund shares to a customer in an amount slightly below the breakpoint at which the customer may obtain a reduced sales load must disclose the breakpoint feature to the investor even though the investor received a prospectus describing it. 27/ The "prospectus requirements were intended to provide the investor with more information than had theretofore been generally available in the ordinary securities transaction"; they "were not intended to

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26/ SEC v. Hasho, 784 F.Supp. 1059, 1107 (S.D.N.Y. 1992); Richard H. Morrow, 53 S.E.C. 772, 781 (1998) ("When recommending securities to a prospective investor, a securities professional must not only avoid affirmative misstatements but also must disclose 'material adverse facts,' including any self-interest that could influence the salesman's representation") (citing Gilbert Zwetsch, 50 S.E.C. 816, 818 (1991)); see also Steven D. Goodman, Exchange Act Rel. No. 43889 (Jan. 26, 2001), 74 SEC Docket 707, 712-13 (noting that a "securities salesman has a duty to ensure that there is a reasonable basis for the recommendations he makes to customers" and that the Applicant ignored the obligation when he "withheld material information from investors"); V.F. Minton Securities, Inc., 51 S.E.C. 346, 350 (1993), aff'd, 18 F.3d 937 (5th Cir. 1994) (Table); Michael J. Fee, 50 S.E.C. 1124, 1125 (1992), aff'd, 998 F.2d 1002 (3d Cir. 1993) (Table).

Under the Division's legal theory, such a duty arose not only from an implied representation of fair dealing, but also from legal principles governing agency and fiduciary relationships. See Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1026 (6th Cir. 1979) ("a broker-dealer is a fiduciary who owes his customer a high degree of care in transacting his business"); Restatement (Second) of Agency §390 cmt a (an agent has a duty to disclose to a principal all facts "which he should realize have or are likely to have a bearing upon the desirability of the transaction from the viewpoint of the principal"). See generally Louis Loss & Joel Seligman, Securities Regulation, 3816, 3820 (3d ed. 2001) (discussing disclosure required of a broker-dealer occupying a fiduciary position).

27/ Kenneth C. Krull, 53 S.E.C. 1101 (1998); Financial Estate Planning, 49 S.E.C. 1, 5 (1978). See also Russell L. Irish, 42 S.E.C. 735, 741-42 (1965), aff'd, 367 F.2d 637 (9th Cir. 1966); Mason, Moran & Co., 35 S.E.C. 84, 90 (1953).

abrogate the greater disclosure duties traditionally imposed on brokers and dealers in a fiduciary position." 28/ To allow a broker or dealer to rely on the prospectus rather than specifically disclose "all material facts likely to have a bearing on the desirability of the transaction from the customer's point of view, including information about the [broker's or dealer's] own interest in the transaction" would permit the broker or dealer to take unconscionable advantage of the customer. 29/

A reasonable investor making a large investment in Class B shares of a mutual fund would consider it material that an investment of the same amount in Class A shares of the same mutual fund entitled the investor to breakpoint discounts not available with the purchase of Class B shares. This information would be important to a reasonable investor, including one interested in pursuing the market-timing strategy offered by Applicants, because it would have a significant impact on the investor's evaluation of the relative cost of pursuing the strategies recommended by Applicants, rather than a buy-and-hold strategy.

Similarly, the Division's further allegations that the Applicants violated the antifraud provisions by failing to disclose to their clients the material information that Class A shares generally outperform Class B shares of the same mutual fund for long-term investors making purchases large enough to take advantage of the breakpoint discounts available for purchases of Class A shares were substantially justified in law. Class A shares generally, although not always, outperform Class B shares for such investors, in part because, in addition to breakpoint discounts, Class B shares generally entail a higher expense ratio than Class A shares, owing to payment of higher fees for the distribution of the fund, commonly referred to as "12b-1 fees," 30/ the payment of the

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28/ Mason, Moran & Co., 35 S.E.C. at 90.

29/ Id.; see also Richardson Greenshields Sec., Inc. v. Mui-Hin Lau, 693 F.Supp. 1445, 1456 (S.D.N.Y. 1988) (noting that a breach of fiduciary duty occurs "when influence has been acquired and abused and when confidence has been reposed and retained"); Financial Estate Planning, 49 S.E.C. at 5. See also generally Disclosure of Breakpoints by Mutual Funds, Securities Act Rel. No. 33-8427, Exchange Act Rel. No. 34-49817, Inv. Co. Act Rel. No. IC-26464, at notes 8 and 17 and accompanying text (June 7, 2004).

30/ Such fees are authorized by Rule 12b-1 under the Investment (continued...)

contingent deferred sales charge on Class B shares, and the fact that Class A shares, unlike Class B shares, entail a declining rate of commission to the broker at breakpoints. Within the context of the broader discussion of the differences in costs and expenses between investments in Class B and Class A shares, the OIP's allegation that the increased commissions received in connection with the Class B investments created a conflict of interest, which Kindschi would be required to disclose under the Advisers Act, was well-supported by existing precedent. 31/ While Class B investors pursuing a market-timing approach might ultimately fare better than Class A investors unable to engage in market-timing, a reasonable investor would want to know that the market-timing strategy would have to be sufficiently successful to compensate for the Class B shares' higher expense ratio in order to outperform Class A shares.

Therefore, we find that the entire case brought by the Division was substantially justified in law.

C. Basis in Fact

We note at the outset that Applicants rely heavily on our dismissal of the case on the merits to support their claim that the Division's case was not substantially justified. Their reliance is misplaced. Our finding that the Division did not meet the

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30/ (...continued)
Company Act of 1940, 17 C.F.R. §270.12b-1.

31/ See Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 191-201 (1963).

The OIP also charged that Flanagan had misrepresented to one of his customer accounts that it was required to make a switch between investments in order to pursue his suggested market-timing strategy. As litigated, the theory behind this charge is that the switch was an unsuitable recommendation fraudulently induced for the purpose of benefitting Flanagan by generating added commissions. Although the charges refer to one switch, rather than a pattern of switching, the basic legal theory is similar to that sustained repeatedly in our cases. See, e.g. Kenneth C. Krull, 53 S.E.C. at 1104-05 (1998); Irish, 42 S.E.C. at 737-40; Winston H. Kinderdick; 46 S.E.C. 636, 637-39 (1976). For this reason, we find that this charge had a reasonable legal basis.

preponderance-of-the-evidence standard necessary to sustain its case 32/ is distinct from the requirement under the EAJA that the agency's position be substantially justified. 33/

The Division presented evidence that, despite the fact that Putnam's prospectus disclosed that purchases of Class B shares would be limited to purchases of $250,000 or less, Kindschi and Spectrum recommended Class B shares of the Putnam High Yield Trust Fund to Wiedrick, for the Plan's $285,000 investment in the market-timing strategy discussed above. 34/ Although Wiedrick testified in general terms that he understood that Class B shares entailed higher expense ratios than Class A shares, he also testified that, when he questioned Kindschi about the split of the $285,000 purchase into separate purchases of $249,999 and $35,001, Kindschi told him that Spectrum's computers could process purchases only up to a certain amount, necessitating the split. 35/ Since the reason for the $250,000 limit on Class B purchases was Putnam's belief that Class B investments larger than that amount were not economical, it is possible to infer, as the law judge did in the Initial Decision, that Wiedrick did not, in fact, fully understand the cost differential between Class A and Class B shares for large investments. It is also possible to infer that Kindschi's false explanation for splitting the purchase was intended to avoid appropriate disclosure, although, on appeal, we ultimately concluded that the evidence, as a whole, was not sufficient to show by a preponderance of the evidence that a violation had occurred.

32/ Steadman v. SEC, 450 U.S. 91 (1981).

33/ Roanoke River Basin, 991 F.2d at 139. The effect of Applicants' argument is to obliterate the difference between two prongs of the EAJA analysis - the determination whether the applicant is a "prevailing party" and the determination whether the government's case is substantially justified. Applicants cite no support for such a proposition.

34/ The Division also presented evidence that Putnam believed that the breakpoints available on Class A shares purchased in amounts over the $250,000 limit "would be more beneficial for the shareholder."

35/ The Division introduced evidence indicating that the gross commission credit received in connection with the purchases of Class B shares was significantly greater than what would have been received if the Plan had purchased Class A shares instead.

As discussed above, the allegations the Division made against Flanagan revolved around his handling of certain accounts for Holloway and his family. The record shows that Holloway and his family received from Flanagan prospectuses of the funds in which Flanagan recommended that they invest and that Holloway and his wife signed papers indicating that they had read these prospectuses. Holloway testified, however, that he would merely skim these prospectuses rather than read them in detail, even though Flanagan testified that he was unaware of this and there is no other evidence indicating that he knew that Holloway did not closely review the prospectuses. Holloway testified that he believed that Flanagan had recommended the Class B shares because they did not have an initial sales charge. Holloway also testified that Flanagan never told him about the availability of breakpoint discounts on large purchases of Class A shares, the difference in expense ratios between Class A and Class B shares, or Putnam's prohibition on purchases of Class B shares in amounts larger than $250,000. This evidence substantially justified bringing an action based on Flanagan's failure to make adequate disclosures to Holloway.

Applicants argue, and the law judge agreed in the EAJA Decision, that there was no substantial factual justification with respect to the four charges that the law judge dismissed in the Initial Decision. Specifically, the law judge dismissed charges involving the accounts over which Holloway's wife, Esther, exercised control because Holloway testified at the hearing that, in fact, his wife, not he, controlled those accounts. Since Esther Holloway did not testify at the hearing, the law judge ruled that there was no evidence concerning whether appropriate disclosures had been made to her. However, Division counsel stated during the hearing that, on the basis of statements made to the Division by Holloway prior to the hearing, the Division believed Holloway would testify that he did control those accounts. Thus, although the Division was ultimately unable to adduce evidence as to Holloway's control at the hearing, it had substantial justification for believing it could establish a factual basis for this allegation when it brought the case. 36/

36/ The EAJA Decision cites to SEC v. Kluesner, 834 F.2d 1438, 1440 (8th Cir. 1987), as a situation in which a witness' unexpected testimony was rejected as a basis for the government's claim that its case had a substantial factual justification. In Kluesner, however, the witness first recanted his initial statement not at trial, but in a deposition two years before the trial, yet the Division still went forward with its charge against Kluesner. There (continued...)

The EAJA Decision found that the Division's charge against Flanagan alleging that he had fraudulently induced a Holloway account to switch investments between funds with similar objectives by misrepresenting that a market-timing strategy would not be available in the absence of that switch was not substantially justified. The Initial Decision, however, found that a switch had occurred between funds with identical objectives, that one of the accounts had held the fund for a short period of time before the switch occurred, that the account suffered harm because the period for the imposition of the fund's contingent deferred sales charge had restarted as a result of the switch, and that Flanagan's explanation for the switch was not credible. 37/ The Initial Decision determined that the Division had failed to meet its burden of proof because it had not provided evidence that Flanagan had made the alleged misrepresentation to his clients. We find that the evidence discussed above produced a reasonable basis for a circumstantial case supporting the switching charge, since it would be possible to infer that Flanagan's non-credible testimony was an attempt to cover up his alleged misrepresentation. Accordingly, we also find that this charge is substantially justified in fact. 38/

36/ (...continued) is nothing in this record to suggest that the Division knew of Holloway's changed testimony prior to the hearing date.

The EAJA Decision also found that the Division had no reasonable factual basis for its charge that Flanagan misled Holloway by telling him that he was required to purchase Class B, rather than Class A, shares in order to take advantage of the market-timing service recommended to him. Holloway testified that Flanagan had never told him any such thing. Given the apparent discrepancy between Holloway's pre-hearing and hearing testimony discussed above, we are unprepared to find that the Division did not have a reasonable basis for making the allegation.

37/ Several of these factors are noted as indicia of fraudulent switching in Commission cases. See, e.g. Krull, 53 S.E.C. at 1102-06 (1998); Irish, 42 S.E.C. at 737-40.

38/ The fourth charge that the law judge found lacking a substantial factual justification was the Division's charge that Kindschi had failed to inform the Plan that it could structure its investments using Class A shares, rather than Class B shares, in a way that would achieve the returns the Plan desired, while reducing expenses. The law judge based (continued...)

Even if we agreed with the law judge's finding that the four charges described above were not factually substantially justified, this would not disturb our finding that the Division's case as a whole was substantially justified in fact. Applicants argue that EAJA case law requires that, if any part of the case is not substantially justified, Applicants receive fees for the entire case or, in the alternative, for that part of the case that was not substantially justified. As discussed above, however, we find that the Supreme Court's precedent in Jean dictates a different conclusion.

Applicants point to language in the Eleventh Circuit's decision in U.S. v. Jones, stating that "the United States cannot escape responsibility for paying EAJA fees unless all its claims were substantially justified." 39/ However, in Jones, the court found "that the overall position of the United States was not substantially justified, although one of the legal theories it asserted was substantially justified." 40/ The court was not suggesting that the "substantial justification" determination should be made on the basis of the strength or weakness of any one portion of the case, but that the "overall position" of the government was determinative. 41/ Thus, the court's conclusion is in accord with

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38/ (...continued)
his determination on the absence of direct evidence that Kindschi had failed to make such a disclosure. However, the Division presented evidence about the breakpoint discounts and other features of Class A shares that showed that Class A shares entailed lower expenses than Class B shares. In addition, as discussed in the text above, Wiedrick's testimony concerning the split of the Plan's investment, breaking its $285,000 investment into two separate investments, indicated that he did not fully understand the cost differences between Class A and Class B shares. Although this circumstantial evidence was insufficient to satisfy the Division's burden of proof on the charge, we find that it provides a reasonable factual basis for bringing the charge.

39/ 125 F.3d 1418, 1427 (11th Cir. 1997).

40/ Id. at 1428.

41/ Applicants cite language from the Eleventh Circuit's decision in Myers v. Sullivan, 916 F.2d 659, 666 (11th Cir. 1990), that they claim demonstrates that Jean entitles a
(continued...)

those cases finding that the government's overall position may be substantially justified notwithstanding a finding that some particular position advanced during the course of litigation may have been unreasonable. 42/

In addressing the situation in which certain government positions are not substantially justified, but the overall government position is substantially justified, the Utu Utu court stated,

> It thus appears that although Congress sought to remove many of the deterrents to challenging government action, it also sought to give the government modest breathing space in conducting otherwise substantially justified

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41/ (...continued)
prevailing applicant to attorney's fees unless all of the government's positions have a reasonable basis in both law and fact. The question presented in Myers was whether applicants had timely filed an EAJA application, and, therefore, the cited language is dicta. Moreover, the cited language does not rely on Jean, but on dicta in an Eleventh Circuit decision, Hudson v. Sec'y of Health and Human Services, 839 F.2d 1453 (11th Cir. 1988), that pre-dates Jean.

42/ See, e.g. Roanoke River Basin, 991 F.2d at 139 (4th Cir. 1993)(". . . we do rely on Jean as directing a more broadly focused analysis that would reject the view that *any* unreasonable position taken by the government in the course of litigation automatically opens the door to an EAJA fee award")(emphasis in original); U.S. v. An Undetermined Number of Defendants, 869 F. Supp. 906, 910 (D. Kansas 1994)(". . . EAJA requires the government's position to be substantially justified, not that each theory advanced in support of that position be substantially justified"); Anthony v. Sullivan, 982 F.2d 586, 589 (D.C. Cir. 1993)("[substantial justification] is to be decided only once during the course of any suit; a single decision as to that element governs eligibility for fees for the entire action"). See also Hanover Potato Products, Inc. v. Shalala, 989 F.2d 123, 131 (3d Cir. 1993)(setting forth requirement that trier of fact must evaluate every significant argument raised by the government to determine if it is substantially justified, as part of its EAJA fee evaluation, in order to evaluate whether the position of the government, as a whole, was substantially justified).

> litigation . . . [A]t some point along a continuum, the government's assertion of various substantially unjustified claims . . . may render an otherwise justified litigation posture substantially unjustified. 43/

We find that, even if the charges dismissed in the Initial Decision were not substantially justified, the overall position of the Division's case, that Kindschi, Flanagan, and Spectrum committed fraud by failing to disclose fully the differences between Class A and Class B shares of mutual funds, has a substantial justification.

Applicants also argue that they are entitled to receive all of their fees on the theory that all of the Division's claims had the same factual bases and the defenses to the claims were intertwined. 44/ This theory is merely a slightly different approach to the Jean "case as an inclusive whole" theory and does not support Applicants' arguments. 45/ Hensley v. Eckerhart arose under the Civil Rights Attorney's Fees Act. 46/ As the court in Utu Utu pointed out, Section 1988 does not contain the language, contained in the EAJA, under which the non-prevailing party may defend a fee petition by showing that its "position . . . was substantially justified."

43/ See Utu Utu, 773 F.Supp. at 1388.

44/ In support of this theory of "intertwined" defenses, Applicants cite Hensley v. Eckerhart, 461 U.S. 424, 435 (1983); Haitian Refugee Center v. Meese, 791 F.2d 1489 (11th Cir. 1986); and Jones, 125 F.3d at 1429.

45/ Like the "case as a whole" theory, the "intertwined" theory recognizes the inherent logistical difficulty in segregating fees and expenses between different claims when all claims are factually intertwined. As the court in Utu Utu stated, ". . . a 'line-item,' issue-by-issue analysis of substantial justification for purposes of fee computations would invite speculative and inherently inaccurate fee awards . . . The figures generated by such calculations would be artificial and imprecise and would necessarily involve district courts, and ultimately appellate courts, in essentially factual disputes not given to precise definition." Utu Utu, 773 F.Supp. at 1388.

46/ 42 U.S.C.A. §1988.

In Haitian Refugee Center, 47/ the court specifically noted that the government was substantially justified in contesting the jurisdiction of the district court only on certain counts of its case, and that the government had pursued an unreasonable case under the law on the core violation charges. In other words, the court found that, notwithstanding the substantial justification of one issue, the government's position as a whole was not substantially justified. Applicants also cite Jones in support of their theory that they should be awarded their full fees and expenses because the factual bases of the claims were intertwined. As we noted above, however, the court in Jones had concluded that the government's case, on the whole, was substantially unjustified before applying the "intertwined theory" to award full fees.

IV.

We find that the Division was substantially justified both in law and fact in bringing proceedings against Applicants. Accordingly, we deny Applicants' claim under the EAJA for

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47/ 791 F.2d at 1500.

attorneys' fees and expenses. 48/ An appropriate order will issue. 49/

By the Commission (Chairman DONALDSON and Commissioners GLASSMAN, GOLDSCHMID, ATKINS, and CAMPOS)

Jonathan G. Katz
Secretary

48/ Although the law judge's initial decision denied Applicants' application for EAJA fees, it also went on to provide a detailed analysis of certain filings and other portions of Applicants' defense for which, the law judge found, Applicants would not have been eligible to receive fees even if they had prevailed in their fee application. Applicants also argued that their fees should be awarded at the rate of $125.00 per hour, as specified under EAJA, rather than the rate of $75.00 per hour set forth in Commission regulations. Applicants further argue that the Commission's decision not to increase the hourly rate at which EAJA fees would be paid is "arbitrary and capricious." Because we deny Applicants' fee application in its entirety, Applicants' arguments on these points are irrelevant, and we do not address them here.

49/ We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Rel. No. 8437 / July 7, 2004

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 49979 / July 7, 2004

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 2258 / July 7, 2004

Admin. Proc. File No. 3-9784-EAJA

In the Matter of the Application of

MICHAEL FLANAGAN, RONALD KINDSCHI, AND SPECTRUM ADMINISTRATION, INC.
c/o Kutack Rock LLP
225 Peachtree Street, N.E.
Suite 2100
Atlanta, GA 30303-1731

ORDER DENYING APPLICATION UNDER THE EQUAL ACCESS TO JUSTICE ACT

On the basis of the Commission's opinion issued this day, it is

ORDERED that the application of Michael Flanagan, Ronald Kindschi, and Spectrum Administration, Inc. for an award of fees and expenses under the Equal Access to Justice Act be, and it hereby is, denied.

By the Commission.

Jonathan G. Katz
Secretary