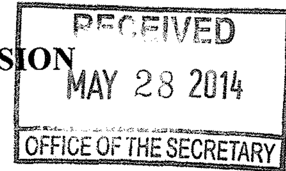
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



In the Matter of

JOHN THOMAS CAPITAL MANAGMENT GROUP LLC d/b/a PATRIOT28 LLC,

GEORGE R. JARKESY, JR.,

JOHN THOMAS FINANCIAL, INC., and

ANASTASIOS "TOMMY" BELESIS,

Respondents.

File No. 3-15255

RESPONDENTS' POST-HEARING MEMORANDUM OF LAW

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Respondents John Thomas Capital Management d/b/a Patriot28 LLC ("JTCM") and George Jarkesy ("Jarkesy") (collectively "Respondents"), submit this their Post-Hearing Memorandum of Law, and show as follows:

Preliminary Statement

There are at least ten compelling reasons to dismiss this case against Respondents:

- The Administrative Proceeding ("AP") is void due to prejudgment of Respondents by the Commission as reflected in the gratuitous findings against Respondents published in a public order issued *prior to* the commencement of Respondents' hearing.

- The Commission engaged in improper *ex parte* communications with Division staff when considering the settlement offer of co-respondents Anastasios Belesis ("Belesis") and John Thomas Financial ("JTF"), in violation of the Administrative Procedure Act and the Commission's own Order Instituting Proceedings ("OIP") in this case.

- The Commission has deprived Respondents of their constitutional rights to due process.
- The Commission has deprived Respondents of their constitutional rights to equal protection.

- The Commission failed to follow its own procedures, including procedures intended to protect constitutional rights.

- The case was mischarged in that a) Respondents were charged with violations of offering fraud provisions when co-respondents JTF and Belesis directly offered and sold the investments to investors, b) co-respondents JTF and Belesis were registered or licensed to sell securities and Respondents were not licensed nor required to be, c) all investors were customers of co-respondents JTF and Belesis, to whom co-respondents owed numerous duties, which they violated, d) the sanctions to JTF and Belesis were light compared to similar conduct in other comparable cases, and e) the evidence adduced during the hearing reflects egregious misconduct by JTF and Belesis, the responsibility for which the Division wrongfully placed on Respondents.

- The evidentiary rulings made during the hearing were inconsistent and unfair, reflect bias against Respondents, and were contrary to public policy.

- The Division failed to prove numerous allegations in the OIP and the necessary elements to establish the alleged violations.

- The remedies sought by the Division are grossly out of proportion to the allegations, the evidence adduced at the hearing, the sanctions levied in other similar cases—especially as to co-respondents Belesis and JTF—and to public policy.
- The Division seeks retroactive application of Dodd Frank penalties, in clear violation of applicable federal law.

Each reason, alone, is a sufficient basis to dismiss this proceeding as to Respondents. The accumulation of all of these reasons in one proceeding compels the conclusion of manifest unfairness in a case that should never have been brought and should have been halted at many points along they way, including now.

<u>The AP is Void Because the Commission Prejudged the Case Against Respondents</u>

The fundamental precept of due process—fully applicable to agency adjudications—is a fair hearing before a fair tribunal. By numerous actions, the Commission has stripped the AP process of minimum standards of fairness, thereby eliminating all possibility of a fair hearing. Then, by publishing its extensive findings and conclusions against Respondents, including finding that Respondents violated a specific statute—*in advance of the adjudication and without considering any evidence or defenses*—the Commission removed all doubt about its ability to serve as a fair tribunal. The Commission flouted the Administrative Procedure Act and the Supreme Court's exhortation that, in agency administrative proceedings, due process "requires an absence of actual bias in the trial of cases."

Several reported cases address the effect of pre-hearing statements by federal agency decision-makers who reveal a position on the facts or law that reflects a prejudgment of the case and bias against the individual subject of the proceeding. *The*

cases are consistent in holding that fundamental due process protections are offended by such bias, resulting uniformly in the nullification of the agency proceedings.

In short, the remarkably uniform case authority establishes that federal commission proceedings are wholly invalidated where these factors are present:

(1) One or more commissioners issue a statement commenting on the case and indicating that the accused individual or entity is in fact culpable;

(2) The statement is made prior to the commission hearing or final decision; and

(3) The accused individual or entity preserves the bias/prejudgment complaint by addressing the issue with the commission prior to final disposition.

The seminal modern case on agency prejudgment is *Antoniu v. S.E.C.*, 877 F.2d 721 (8th Cir. 1989), *cert. denied,* 110 S. Ct. 1296 (1990), where a single SEC commissioner made published pre-hearing statements indicating what he thought of Mr. Antoniu—who had recently been convicted of securities fraud—and commenting favorably on the Commission's position in the administrative proceeding. That commissioner, Charles C. Cox, delivered a speech in Denver after the OIP was issued and while the respondent's statutory disqualification hearing was pending. The Commission was seeking a lifetime ban from securities-related employment. The entirety of Commissioner Cox's statements:

> Mr. Antoniu, on the other hand, can be appropriately termed a violator, for he pled guilty to criminal violations of the federal securities laws. In his positions at Morgan Stanley and Kuehn [sic], Loeb and Company, he provided inside information on several occasions to accomplices who traded while in possession of that information. Although he was prosecuted for this conduct, Mr. Antoniu recently applied to become associated with a broker-dealer. Apparently, Mr. Antoniu believed that, since his rehabilitation was complete, there was no further reason to prevent his future dealings in the securities industry. In that case, the Commission responded by denying Mr. Antoniu's request for association.
>
> One issue that frequently arises with respect to individuals whom I call "indifferent violators" is the length of time that a Commission remedy should remain in effect. This may come up when originally structuring the settlement of an injunction or an administrative proceeding, or in later applications for relief

> from an injunction or Commission order. * * * *In the case of Mr. Antoniu, his bar from association with a broker-dealer was made permanent.*

877 F.2d at 723 (emphasis in original). The text of the speech was printed and distributed by the Commission. Mr. Antoniu moved for the disqualification of the entire Commission based on the pre-decision bias evident from the published comments in the speech. His motion was denied, and Commissioner Cox initially refused to recuse himself from further involvement in the case. *Id.* Some eighteen months later—the day the Commission issued its decision affirming the ALJ's initial decision granting a lifetime ban—Commissioner Cox recused himself, presumably from the final deliberation and Commission vote. [1] *Id.*

The court, however, was resolute in finding that the proceeding against Mr. Antoniu was devoid of due process. Noting first "the fundamental premise that principles of due process apply to administrative adjudications," *see Amos Treat & Co. v. SEC,* 306 F.2d 260, 264 (D.C. Cir. 1962), the court recited the Supreme Court's description of the minimal rudiments of due process from *In re Murchison,* 349 U.S. 133, 136 (1955): "A fair trial in a fair tribunal is a basic requirement of due process. Fairness of course requires an absence of actual bias in the trial of cases."

Most importantly, the *Antoniu* court pointed out, the Supreme Court has demanded not only a fair proceeding, but also that "justice must satisfy the appearance of justice." *Murchison, at 136, citing Offutt v. United States,* 75 S. Ct. 11, 13 (1954). So the relevant inquiry was "whether Commissioner Cox's post-speech participation in the . . . proceedings comported with the appearance of justice." The court thus concluded:

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[1] The Commission thought so little of Antoniu's prejudgment complaint that the opinion and order did not even acknowledge or discuss it. *See In the Matter of Adrian Antoniu,* 48 S.E.C. 909, Admin. Proc. File No. 3-6566 (1987).

> After reviewing the statements made by Commissioner Cox, we can come to no conclusion other than that Cox had "in some measure adjudged the facts as well as the law of a particular case in advance of hearing it." *Gilligan, Will & Co. v. SEC,* 267 F.2d 461, 469 (2d Cir.), *cert. denied,* 361 U.S. 896, 80 S.Ct. 200, 4 L.Ed.2d 152 (1959). Even though Cox recused himself prior to the filing of the SEC's final decision, there is no way of knowing how Cox's participation affected the Commissioner's deliberations. Accordingly, **we nullify all Commission proceedings** (including the Commission's rejection of Antoniu's proposed settlement) in which Commissioner Cox participated occurring after Commissioner Cox's speech was given and remand the case to the Commission with directions to make a de novo review of the evidence, without any participation by Commissioner Cox. It is so ordered.

877 F.2d at 726 (emphasis supplied).

In contrast to the instant case, the court in *Antoniu* was confronted with only a single commissioner who had "adjudged the facts as well as the law of a particular case in advance of hearing it." The court thus had available the option of remanding the matter back to the Commission with orders to start over and exclude the biased commissioner from any involvement in the case. In Respondents' case, the *entire Commission* has "adjudged the law as well as the facts" in great depth, in advance of even the hearing before the administrative law judge. It is therefore impossible to fashion a remand procedure that can meet the most rudimentary demands of due process: "a fair trial in a fair tribunal." Neither the Constitution nor the APA provide for an alternative process for administrative adjudication when the agency's own actions disqualify it.

Significantly, only two other reported cases—both D.C. Circuit opinions—address a preserved complaint about commissioner prejudgment of a federal agency decision. Both were cited by the *Antoniu* court, and both reached exactly the same conclusion. In *Texaco, Inc. v. Fed. Trade Comm'n,* Texaco and B.F. Goodrich were facing an administrative hearing on charges that they violated the Federal Trade

Commission Act by effectively coercing Texaco dealers to distribute Goodrich products through a commission agreement between the two companies, to the disadvantage of competing rubber product companies. 336 F.2d 754 (D.C. Cir. 1964), *vacated on other grounds,* 85 S. Ct. 1798 (1965). Just as in *Antoniu*, a commissioner—new FTC Chairman Dixon—delivered a speech in Denver, in which he expressed the Federal Trade Commission's intent to crack down on anti-competitive practices. The relevant comments, which were likewise distributed in a press release, were made to a convention of petroleum retailers:

> We at the Commission are well aware of the practices which plague you and we have challenged their legality in many important cases. You know the practices- price fixing, price discrimination, and overriding commissions on [tires, batteries and accessories]. You know the companies- Atlantic, Texas, Pure, Shell, Sun, Standard of Indiana, American, Goodyear, Goodrich, and Firestone. Some of these cases are still pending before the Commission; some have been decided by the Commission and are in the courts on appeal. You may be sure that the Commission will continue and, to the extent that increased funds and efficiency permit, will increase its efforts to promote fair competition in your industry.

Id. at 759. Stating the obvious—that a disinterested observer could conclude that the commissioner had "in some measure" prejudged the specific case before it, stripping from the proceedings the "very appearance of complete fairness"—the D.C. Circuit summarily ruled that the commissioner's "participation in the hearing amounted in the circumstances to a denial of due process which invalidated the order under review." *Id.*, at 760.

The D.C. Circuit confronted a similar complaint in *Cinderella Career & Finishing Schools, Inc. v. Fed. Trade Comm'n.*, a deceptive advertising case where the commissioner publicly denounced the respondents in a pending administrative

proceeding although without naming them or even referring to the specific case. 425 F.2d 583 (D.C. Cir. 1970). The court contrasted the Commission's general authority to comment publicly on pending cases and the "reason to believe" that alleged violations have occurred:

> This does not give individual Commissioners license to prejudge cases or to make speeches which give the appearance that the case has been prejudged. Conduct such as this may have the effect of entrenching a Commissioner in a position which he has publicly stated, making it difficult, if not impossible, for him to reach a different conclusion in the event he deems it necessary to do so after consideration of the record. There is a marked difference between the issuance of a press release which states that the Commission has filed a complaint because it has 'reason to believe' that there have been violations, and statements by a Commissioner after an appeal has been filed which give the appearance that he has already prejudged the case and that the ultimate determination of the merits will move in predestined grooves. While these two situations—Commission press releases and a Commissioner's pre-decision public statements—are similar in appearance, they are obviously of a different order of merit.

Id. at 590. The court invalidated the Commission's proceedings while noting that it was of no moment that the public statements did not specifically refer to the respondents: "the reasonable inference a disinterested observer would give these remarks would connect them inextricably with this case." Id. at 592, n. 10.

The premature and improper findings in this case are broad enough to establish liability under each of the statutes charged and, thus, give rise to each of the sanctions and remedies the Division seeks. The Commission misconduct here goes far beyond a single comment by a lone Commissioner in a public statement or an overly-aggressive press release. Instead, the *entire Commission* issued a public Order that makes extensive findings of fact that recite or summarize virtually all of the Division's unproven allegations in the OIP as true and correct, and adjudged the Adviser (Jarkesy) and

Manager (JTCM) to have violated the law as charged. The verdict was pronounced before the trial started.

The Commission's pre-hearing verdict requires recusal of the Commissioners and nullifies the AP proceedings against Respondents. Because there is now no Commission to oversee and review the findings of the ALJ, and no legally-valid final Commission order from which to appeal to a circuit court, the entire administrative adjudicatory structure fashioned by Congress in the APA has been annihilated. Tellingly, the Division revealed (in a footnote to its opposition brief) that the finding of a primary violation by Respondents was necessary to give legal effect to the settlement of aiding and abetting charges against Belesis and JTF.

The Division and Commission argue that the footnote in the Settlement Order that reads, "the findings herein . . . are not binding on any other person or entity in this or any other proceeding," saves the Commission from the claim of prejudgment. But this does not change the fact that the Commission has decided Plaintiffs' guilt. Moreover, the footnote only disclaims the binding of "other" persons and entities; that the findings bind the Commission itself is a reality left undisturbed. It is the *Commission's* prejudgment that nullifies the AP. For this reason and many others explained below, the Commission has rendered the AP against Respondents a nullity, and it should be dismissed.

<u>The AP Should Be Dismissed Due to Improper *Ex Parte* Communications with the Division of Enforcement Prior to the Hearing</u>

Persons involved in the investigation and prosecution of the AP also participated in the settlement discussions and recommendation of the settlement to the Commission. This participation and recommendation constitutes improper *ex parte* communications.

The OIP issued by the Commission in this case states:

> In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice.

The communications between the Division staff and the Commission in resolving the claims as to the Settling Respondents without first procuring a waiver or providing notice and an opportunity to be heard by Respondents, violates the Commission's own admonition in the OIP, as well as the Rules of Practice and the APA.

The Commission's Enforcement Manual of 2013 ("Manual") specifically permits the Division staff assigned to investigate and prosecute a case to also engage in settlement negotiations and make settlement recommendations to the Commission. This long-standing practice is memorialized in numerous places in the Manual. Some examples are:

- Division staff is instructed .to report settlement discussions in required Quarterly Reviews of Investigations and Status Updates. (Section 2.1.2; pg. 8)
- Division staff may engage in appropriate settlement discussions with the recipient of the Wells notice. (Section 2.4; pg. 25)
- The Commission considers and votes on some of the Division's recommendations in closed meetings. Generally, recommendations that are eligible to be considered at closed meetings include recommendations to institute, modify, or settle an enforcement action or to consider an offer of settlement or other proposed disposition of an enforcement action. (Section 2.5.2.1, pg. 26)
- At a closed meeting, Division staff orally presents a recommendation to the Commission and answers any questions before the Commission votes on the recommendation. Except in unusual circumstances, the Commissioners receive a copy of the Division's recommendation prior to the closed meeting. Division staff should be prepared to answer the questions that are likely to be asked by the Commissioners and should contact the Commissioners' offices prior to the meeting to learn of any particular concerns or questions about the recommendation. (Section 2.5.2.1; pg. 27)
- The Manual instructs the Division staff to obtain an executed Certification as to

Completeness when recommending a settlement offer from an entity or individual. In the Certification, the settling party acknowledges that the Commission has relied upon, among other things, the completeness of his production. (Section 3.2.6.2.6; pgs. 58-59)

- In entering into a cooperation agreement, the cooperating individual or company acknowledges that, although the Division has discretion to make enforcement recommendations, only the Commission has the authority to approve enforcement dispositions and accept settlement offers. (Section 6.2.2; pg. 126)
- Where cooperation credit is being recommended to or has been authorized by the Commission in settlements, Division staff should include standard language relating to cooperation in the related Offers or Consents, unless such disclosure would not advance the goals of the Commission's cooperation program or would adversely .affect related ongoing investigations or proceedings. Modifications to this standard language should not be made without first consulting with staff in the Office of Chief Counsel or the Chief Litigation Counsel. (Section 6.2.2; pg. 127)
- As discussed in Section 6.2.2 of the Manual, where cooperation credit is being recommended to or has been authorized by the Commission in settlements, the staff should include standard language relating to cooperation in Offers, Consents, or other dispositions and reference the individual or company's cooperation in the supporting paragraphs of the related litigation and/or press releases, unless such disclosure would not advance the goals of the Commission's cooperation program or would adversely affect related ongoing investigations or proceedings. (Section 6.3; pg. 134)

By Commission practice and published procedures, the memorandum to recommend the settlement to the Commission, along with Settling Respondents' written offer of settlement ("Offer") and the Order are routinely—and necessarily—prepared by persons involved in the investigation and/or prosecution of the case. The recommendation memorandum is a one-sided communication that discusses the relative culpability of the settling respondents to the non-settling respondents, and thus is by definition a prohibited extrajudicial communication—at least if presented without first obtaining a waiver or in a proceeding without notice to all relevant parties.

Here, regardless of who actually prepared these documents, the Order reveals that persons involved in the investigation and prosecution of the case-directly or indirectly-contributed to the substance of the Order. The Order reflects updated circumstances

stances as to the Belesis and JTF (subsequent to the issuance of the OIP) and that the Commission made determinations of the disgorgement amount, the penalty amounts, and consent by Belesis to lesser charges than in the OIP, all of which required the input of the investigating and prosecuting staff. This conduct violates the Commission's own OIP and the APA.

The Commission justifies its violative conduct by citing an exception it has created for itself, relying on its own "unbroken line of decisions" as its authority. These internal orders violate the plain language of the APA, as well as the OIP issued in this case.[2]

The AP is Void Because the Commission Failed to Follow its Own Rules of Practice

It is axiomatic as a matter of Due Process that rules promulgated by a federal agency that regulate the rights and interests of others are controlling upon the agency. *United States ex rel. Accardi v. Shaughnessy,* 74 S. Ct. 499 (1954); *Columbia Broad. Sys., Inc. v. United States,* 62 S. Ct. 1194, 1202-03 (1942). "Where the rights of individuals are affected, it is incumbent upon agencies to follow their own procedures. This is so even where the internal procedures are possibly more rigorous than otherwise would be required." *Morton v. Ruiz,* 94 S. Ct. 1055, 1074 (1974).

In the course of Plaintiffs' AP, the SEC's Division has deliberately hidden *Brady* material—both in the withheld witness notes and the jumbled 700gb "document dump." In an isolated nod to discovery precepts, the SEC's Rules of Practice require the Division

[2] The Commission's affinity for its own decisional decrees—despite contrary and binding case authority from Article III courts—contrasts with the Division's resort to federal case law when that alternative seems helpful to its case against Respondents.

to comply with the *Brady* doctrine. *See* 17 C.F.R.§ 201.230(b)(2).[3] On interlocutory appeal, the Commission published an opinion using mischaracterized factual assertions and bizarre logic in a tortured attempt to discount the *Brady* violations, ultimately rejecting Plaintiffs' *Brady* complaints on the grounds that Plaintiff Jarkesy had failed to demonstrate that the withheld evidence would tend to impeach *himself*. The history in this case firmly establishes that the SEC does not follow the strict dictates of its own Rules of Practice. Without the *Brady* information, the Plaintiffs cannot defend themselves on the merits of the Division's claims and cannot appeal the *Brady* error, since the relevant material will not be in the case record.

The Court observed in *United States v. Caceres* that "[a] court's duty to enforce an agency regulation is most evident when compliance with the regulation is mandated by the Constitution or federal law." 99 S. Ct. 1465, 1470 (1979). In response, the courts have generally required stricter compliance with regulations borne of statutory or constitutional rights. *See Battle v. FAA,* 393 F.3d 1330, 1336 (D.C.Cir. 2005) ("[A] court's duty to enforce an agency regulation [, while] most evident when compliance with the regulation is mandated by the Constitution or federal law, embraces as well agency regulations that are not so required.") (citations omitted). The *Brady* discovery rule embodied in the SEC's Rules of Practice 230(b)(2) is a regulation borne of the due process requirement of fundamental fairness in agency adjudicatory proceedings. Given that this Rule was violated in multiple ways against Respondents, the AP is invalidated and should be dismissed.

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[3] The Division's *Brady* obligation also encompasses impeachment material covered by *Giglio v. U.S.*, 92 S. Ct. 763 (1972), such as witnesses' criminal records, information reflecting on witness competence and credibility, agreements made with the witness, and information that casts doubt on a witness's statement.

Respondents' Constitutional Rights Were (and continue to be) Violated

In addition to the due process violation discussed above, the Commission has violated and continues to violate Respondents' constitutional rights.

Denial of Respondents' Rights to Due Process

As described above, by its deliberate actions—approved by the ALJ and ratified by the Commission—the Division has prevented Plaintiffs from accessing the relevant evidence by effectively hiding it in a 700 gb "document dump" and providing no effective means of identifying the contents. Producing millions of documents incapable of being searched reliably is no better than refusing to produce documents at all. Federal courts thus routinely hold that large, haphazard document productions violate the Federal Rules of Civil Procedure. *See, e.g., Residential Contractors, LLC v. Ace Prop. & Cas. Ins. Co.,* No. 2:05-cv-01318-BES-GWF, 2006 U.S. Dist. LEXIS 36943, at *7 (D.Nev. 2006) ("The Court does not endorse a method of document production that merely gives the requesting party access to a 'document dump,' with an instruction to 'go fish ....'"); *Mizner Grand Condo. Ass 'n v. Travelers Prop. Cas. Co. of Am.,* 270 F.R.D. 698, 700-01 (S.D. Fla. 2010) (granting defendants' motion to compel after plaintiff offered for inspection approximately 10,000 unsegregated and uncategorized documents that essentially required defendants to "examine and sort through each individual file folder.").

The SEC has been admonished in the past for using such tactics. In *SEC v. Collins & Aikman Corp.,* 256 F.R.D. 403, 413 (S.D.N.Y. 2009). the court required the Commission to produce 175 file folders created by its litigation attorneys. In reasoning applicable here, the court stated, "While the responsive documents exist somewhere in

the ten million pages produced by the SEC, the production does not respond to the straightforward request to identify documents that support the allegations in the Complaint, documents [defendant] clearly must review to prepare his defense." *Id.* at 410. In *United States v. Skilling*, the court explained the proper procedure for making evidence accessible to parties faced with massive government data dumps:

> There is little case law on whether a voluminous open file can itself violate *Brady*, and the outcomes of these cases seem to turn on what the government does in addition to allowing access to a voluminous open file. *See, e.g., United States v. Ferguson*, 478 F. Supp. 2d 220, 241–42 (D. Conn. 2007); *United States v. Hsia*, 24 F. Supp. 2d 14, 29–30 (D.D.C. 1998); *Emmett v. Ricketts*, 397 F. Supp. 1025, 1043 (N.D. Ga. 1975). In the present case, the government did much more than drop several hundred million pages on Skilling's doorstep. The open file was electronic and searchable. The government produced a set of "hot documents" that it thought were important to its case or were potentially relevant to Skilling's defense. The government created indices to these and other documents. The government also provided Skilling with access to various databases concerning prior Enron litigation. . . . But considering the additional steps the government took beyond merely providing Skilling with the open file . . . we hold that the government's use of the open file did not violate Brady.

554 F.3d 529, 577 (5th Cir. 2009) *aff'd in part, vacated in part, and remanded on other grounds*, 130 S. Ct. 2896 (2010). Here, the Division took *none* of the additional steps present in *Skilling*; the multiple databases and files produced are searchable, but only individually, meaning that several different databases and PDF files must be searched seriatim, adding to the monstrous chore of reviewing the data. No lists of "hot documents" were provided, nor were indices provided, and the file directories were mislabeled. If there is *Brady* material in the data the Division provided, it would likely

take *years* for Respondents to find it.[4] Such a procedure does not comport with due process (or for that matter a meaningful disclosure of *Brady* material).

Subsequent to *Skilling*, a district court required the government to identify the *Brady* material in a multi-gigabyte, multi-million-page production. *United States v. Salyer*, Cr. No. S–10–0061 LKK (GGH), 2010 WL 3036444 at *4 (E.D. Ca. Aug. 2, 2010). In response to the government's argument that a *Brady* review would be an "impossible" burden, the court reasoned:

> During the course of the years long investigation in this case, the government personnel seemed to be able to segregate that evidence which would be useful in the prosecution in terms of guilt, but apparently made no efforts to segregate that evidence which runs counter to the charges. Assuming for the moment that some *Brady/Giglio* evidence, as the court has defined it below, exists, the reviewing personnel apparently made no note of the evidence, or merely having noted it, "stuck it back" in the ever-increasing pile to be an inevitably hidden part of the mass disclosure. The obligations imposed by *Brady et al.* have been well established for years, and should be anticipated in every case during the investigation phase. **If the government argues that it is now "impossible" to comply with the burden of reviewing evidence for identification purposes, the government more or less made its own bed in this matter by making it impossible.**

Salyer, 2010 WL 3036444 at 4 (emphasis added).

Putting Respondents to trial with the opportunity to only review a miniscule percentage of the evidence that supported the issuance of the OIP is manifestly unfair and violates Respondents' rights to due process. For that reason, the AP should be dismissed against Respondents.

[4] The Division argued that there are many duplicate documents and emails; however, the only way to determine whether a document or email is a duplicate of another is to manually review and carefully compare each document.

Denial of Respondents' Rights to Equal Protection—Arbitrary Selection of AP Forum

The SEC arbitrarily chose to litigate the claims against Plaintiffs in an administrative proceeding instead of filing suit on the same claims in federal court, and by its action contravened Respondents' equal protection rights in two ways. First, the Commission's arbitrary decision constituted invidious discrimination against Respondents in violation of their rights to equal protection under the law, since by their decision the Commission deprived Respondents of a fundamental right, to wit: their right to jury trial as guaranteed by the Seventh Amendment—subjecting the discrimination to strict scrutiny analysis. Second, by intentionally, arbitrarily and malevolently casting Respondents into the administrative process, effectively stripping Respondents of most of their due process rights, their jury trial rights and all of the procedural protections of the federal rules of evidence and procedure, while selecting federal court to pursue identical statutory claims against other similarly-situated defendants, the Commission has contravened Respondents' equal protection rights guaranteed by the Due Process Clause of the Fifth Amendment pursuant to the equal protection "class of one" doctrine. Respondents have been placed into a forum where statistical analysis reveals that *very* few respondents are successful, instead of the courtroom where the SEC enjoys a much more modest success rate.[5] The adverse effect is palpable.

Respondents have identified a number of similarly situated parties—individuals and entities currently charged with precisely the same securities fraud violations—under

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[5] Analysis of publicly available AP records covering the last three years reveals that the Division has enjoyed a success rate in similar actions approaching 100%, while according to a recent study by *The New York Times*, in FY 2011 the SEC was successful in only 63% of its enforcement actions in federal court. See "At the S.E.C., a Question of Home-Court Edge," *The New York Times*, 10/5/13, at http://www.nytimes.com/2013/10/06/business/at-the-sec-a-question-of-home-court-edge.html.

the *same sections* of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Advisers Act of 1940—who were likewise not registered with the SEC and who could have been charged by OIP and thrust into the administrative process but who were instead allowed to defend themselves in federal court. These similarly-situated parties—called "comparators" in equal protection parlance—are easily identified from public records. These much more fortunate defendants are identical to Respondents in all material respects. The referenced comparators are listed and described in Exhibit A, attached hereto and incorporated herein for all purposes.

Denial of Respondents' Rights to Equal Protection—Deprivation of Right to Jury Trial

Perhaps the gravest of the consequences of the Commission's actions irrationally placing Plaintiffs into the very disadvantageous AP setting is the effective denial of Plaintiffs' Seventh Amendment right to trial by jury. [6] Despite much scholarly criticism[7] the Supreme Court has long permitted Congress to designate certain categories of government claims for litigation exclusively in an administrative forum, where the expertise of a regulatory agency with specialized, esoteric expertise and knowledge of a particular industry is deemed an acceptable justification for keeping these cases out of Article III courts, effectively eliminating the citizen's Seventh Amendment rights. *See Granfinanciera, S.A., v. Nordberg*, 109 S.Ct. 2782 (1989); *Atlas Roofing Co. v. Occupational Safety & Health Review Comm'n*, 97 S. Ct. 1261 (1977); *NLRB v. Jones & Laughlin Steel Corp.*, 57 S.Ct. 615 (1937). But the Seventh Amendment applies with full

[6] The Seventh Amendment provides that "In suits at Common Law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in any court of the United States, than according to the rules of the common law."

[7] *See, e.g.*, Redish and LaFave, *Seventh Amendment Right to Jury Trial in Non-Article III Proceedings: A Study in Dysfunctional Constitutional Theory*, 4 WM. & MARY BILL OF RIGHTS J. 407 (1995).

vigor to securities fraud enforcement actions in Article III courts where the SEC seeks monetary penalties.[8]

The Seventh Amendment should be recognized as a fundamental right, at least for purposes of equal protection analysis under the Fifth Amendment due process clause.[9] It is clear that "[t]he [Seventh Amendment] right to trial by jury 'is of such importance and occupies so firm a place in our history and jurisprudence that any seeming curtailment of the right to a jury should be scrutinized with the utmost care.'" *Chauffeurs, Teamsters & Helpers, Local No. 391 v. Terry,* 494 U.S. 558, 565 110 S.Ct. 1339, 1344-45 (1990) (quoting *Dimick v. Schiedt,* 293 U.S. 474, 486 (1935)). Even so, the Seventh Amendment's status as a "fundamental" right has yet to be established under modern Fourteenth Amendment equal protection jurisprudence, the Court having last considered the issue in 1931[10] at a time well before the Court had even established the contemporary mode of analysis for equal protection incorporation.[11] The Seventh Amendment remains unincorporated largely as a result of the fact that forty-eight of the fifty states have their own constitutional versions of a right to jury trial in civil cases (the other two have statutorily based protections of the right), and the subtle differences among them have led

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[8] In *Feltner v. Columbia Pictures Television, Inc.*, 118 S.Ct. 1279, 1287-88 (1998), the Court expanded the Seventh Amendment jury trial right beyond determination of liability to the assessment of penalties as well: "[I]f a party so demands, a jury must determine the actual amount of statutory damages . . . in order "to preserve 'the substance of the common-law right of trial by jury.' " *SEC v. Lipson,* 278 F.3d 656 (7th Cir. 2002) (Seventh Amendment jury trial right applies where SEC seeks civil penalties for securities fraud).

[9] While the Equal Protection Clause of the Fourteenth Amendment by its terms applies exclusively to the states, the Supreme Court has found a comparable equal protection component applying to the federal government in the Fifth Amendment's Due Process Clause. *See, e.g., Bolling v. Sharpe,* 347 U.S. 497 (1954).

[10] *See Hardware Dealers Mut. Fire Ins. Co. of Wisconsin v. Glidden Co.,* 284 U.S. 151, 158 (1931), where the Court declined, without discussion, to glean a jury trial right from the Fourteenth Amendment's *Due Process* Clause.

[11] The controlling standard for such incorporation is whether the right in question is "fundamental." *See, e.g., Duncan v. Louisiana,* 391 U.S. 145, 149 (1968).

the Supreme Court to avoid preempting the states' ability to implement those differences.[12]

Whether the Seventh Amendment right to trial in civil cases is a "fundamental right" triggering strict scrutiny analysis in federal enforcement actions under modern equal protection jurisprudence appears to be a question of first impression,[13] but even a cursory examination of the history and purpose of the Seventh Amendment compels the conclusion that it is. The Declaration of Independence lists as one of the grievances against the English "depriving us in many cases, of the benefits of Trial by Jury." Thomas Jefferson wrote: "I consider [trial by jury] as the only anchor imagined by man, by which a government can be held to the principles of its constitution." 3 *The Writings of Thomas Jefferson* 71 (Washington ed. 1861).

Justice Black once wrote that "[t]he founders of our government thought that trial of fact by juries rather than by judges was an essential bulwark of civil liberty." *Galloway v. United States,* 63 S. Ct. 1077, 1090 (1943) (Black, J., dissenting). Then-Justice Rehnquist reminded us that "[i]t is perhaps easy to forget, now more than 200 years removed from the events, that the right of trial by jury was held in such esteem by the colonists that its deprivation at the hands of the English was one of the important grievances leading to the break with England." *Parklane Hosiery Co., Inc. v. Shore,* 99 S. Ct. 645, 656 (1979) (Rehnquist, J., dissenting). Rehnquist admonished that "[t]he founders of our Nation considered the right of trial by jury in civil cases an important

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[12] Uniform state protection of the right to jury trial strongly suggests that the right is fundamental.

[13] The Court has recited the 1931 *Hardware Dealers* conclusion in more recent cases but without substantively revisiting the issue. *See Curtis v. Loethar*, 94 S. Ct. 1005 (1974). In none has the Court addressed the Seventh Amendment's status as a fundamental right for Fifth Amendment equal protection purposes in the context of federal enforcement actions. *See also, In re Japanese Elec. Prods. Antitrust Lit.*, 631 F.2d 1069, 1085 (3rd Cir. 1980).

bulwark against tyranny and corruption, a safeguard far too precious to be left to the whim of the sovereign...." 439 U.S. at 657-58 (footnote omitted). Historians have documented the centrality of the Seventh Amendment to the Bill of Rights. Indeed, the Framers saw the right to a jury in civil cases as so fundamental to ordered liberty that even before the delegates to the Constitutional Convention had left Philadelphia, plans were under way to attack the proposed Constitution on the ground that it failed to contain a guarantee of civil jury trial in the new federal courts. *Id.* at 657. *See also* Wolfram, *The Constitutional History of the Seventh Amendment,* 57 MINN. L. REV. 639, 662 (1973).

Of equal importance is the well-understood purpose of the right. It has been noted that "the civil jury is a cornerstone of democratic government, a protection against incompetent or oppressive judges, and a way for the people to have an active role in the process of justice." Moses, *What the Jury Must Hear: The Supreme Court's Evolving Seventh Amendment Jurisprudence,* 68 GEO. WASH. L. REV. 183, 183 (2000), citing Gunther, *The Jury in America,* xiii-xviii (1988). *See also* Klein, *The Myth of How to Interpret the Seventh Amendment Right to a Civil Jury Trial,* 53 OHIO ST. L.J. 1005, 1032 (1992) ("In 1789 there was a shared perception that guaranteeing the right to civil jury trials was important. Without an impartial jury, the individual citizen had no ability to check of the power of the sovereign in a civil courtroom."). *See also id.* at 1034 ("The principle captured in the amendment is that this specter of unchecked authority [in the courtroom] was unacceptable.").

To be clear, Plaintiffs do not here complain that *Congress* had no right to separate them from their Seventh Amendment rights by designating securities fraud enforcement actions for adjudication in an administrative forum. Plaintiffs instead challenge the

unguided, unlimited discretion exercised by the SEC to determine, by itself, which cases and which defendants—including those identically situated—are to be adjudicated with full Seventh Amendment protections and ones which are not. Because the discrimination against Plaintiffs in the exercise of this fundamental right cannot survive strict scrutiny, the SEC's actions run afoul of Plaintiffs' equal protection rights under the Due Process Clause of the Fifth Amendment, and the SEC should be enjoined from its continuing violation through its persisting in subjecting Plaintiffs to the pending administrative proceeding.

To justify the power vested in Congress to designate certain categories of government claims for litigation exclusively in an administrative forum, the Supreme Court has deferred to the legislative branch and its judgment that the specialized expertise of regulatory agencies was necessary for the administration of the modern bureaucratic state. *See Granfinanciera,* 109 S.Ct. at 2782; *Atlas Roofing Co.*, 97 S. Ct. at 1261. This deference to Congress allows it to "adopt innovative measures such as negotiation and arbitration with respect to rights created by a regulatory scheme." *Thomas v. Union Carbide Agric. Prod. Co.*, 105 S. Ct. 3325, 3340 (1985). The Supreme Court has thus essentially determined that Congress can be trusted with the power to decide in its legislative wisdom which categories of regulated parties would be stripped of the Seventh Amendment right to trial by jury.

But central to the Court's entrusting this circumscribed constitutional-deprivation power to the legislative branch are two underlying premises that Congress disregarded through its piecemeal additions to the SEC's enforcement authority. The first is that Congress's relegation of such classes of disputes to administrative adjudication is to be

"exclusive." The Court has repeatedly stressed that "when Congress creates procedures "designed to permit agency expertise to be brought to bear on particular problems," those procedures "are to be exclusive." *Free Enterprise v. Pub. Co. Accounting Oversight Bd.*, 130 S.Ct. 3138 (2010); *Whitney Nat'l Bank in Jefferson Parish v. Bank of New Orleans & Trust Co.,* 85 S. Ct. 551, 557 (1965). The second premise is that the matters consigned to administrative adjudication involve "issues of fact not within the conventional experience of judges or cases requiring the exercise of administrative discretion." *Whitney Nat'l Bank, supra,* 85 S.Ct. at 558. As the Court rationalized long ago, "[u]niformity and consistency in the regulation of business entrusted to a particular agency are secured, and the limited functions of review by the judiciary are more rationally exercised, by preliminary resort for ascertaining and interpreting the circumstances *underlying legal issues to agencies that are better equipped than courts* by specialization, by insight gained through experience, and by more flexible procedure." *Far East Conference v. United States*, 342 U.S. 570, 574-575, 72 S.Ct. 492, 494 (1952) (emphasis supplied).

Neither of those premises applies to the power Congress has now vested in the SEC to decide how to prosecute enforcement actions for securities law violations. Apparently overlooked by Congress is that the AP process at the SEC is *not* exclusive, and that the agency is no better equipped than federal courts to adjudicate securities fraud allegations—federal courts do this all the time, and have done so—with juries—since the statutory violations were first defined in 1933, 1934, and 1940.

Moreover, the Supreme Court has never allowed this unique legislative prerogative—the constitutional power to relegate certain classes of controversies to non-Seventh Amendment treatment—to be delegated yet again by Congress to the executive

branch, much less to the very agency filing the enforcement action. The agency "power creep" afforded by haphazard legislative amendments—what the D.C. Circuit once called "legislation by potpourri"[14]—has vested the SEC with what the Supreme Court characterizes as a uniquely legislative function that includes the unbridled and unguided power to decide who gets a Seventh Amendment right and when they get it.

But the "'fact that a given law or procedure is efficient, convenient, and useful in facilitating functions of government, standing alone, will not save it if it is contrary to the Constitution,'" for "'[c]onvenience and efficiency are not the primary objectives—or the hallmarks—of democratic government.' " *Bowsher* [*v. Synar*, 478 U.S. 714], at 736, 106 S.Ct. 3181; *Free Enterprise,* 130 S.Ct. at 3155. Moreover, the separation of powers does not depend on whether "the encroached-upon branch approves the encroachment," *New York v. United States,* 505 U.S. 144, 182, 112 S.Ct. 2408 (1992).

That Congress may not delegate legislative power to the executive branch is "universally recognized as vital to the integrity and maintenance of the system of government ordained by the Constitution." *Marshall Field & Co. v. Clark,* 12 S. Ct. 495, 504 (1892). The unconstitutional delegation doctrine derives its constitutional underpinning from Article I's vesting of "all legislative powers" with Congress, the idea that each branch of the federal government has its own independence. *Mistretta v. United States,* 109 S. Ct. 647, 654 (1989). Congress's ability to endow a coordinate branch of government with a measure of discretion is circumscribed by the requirement that it must "lay down by legislative act an intelligible principle to which the person or body

[14] *Five Flags Pipe Line Co. v. Department of Transp.,* 854 F.2d 1438, 1441 (1988).

authorized to [exercise the delegated authority] is directed to conform." *J.W. Hampton, Jr. & Co. v. United States,* 48 S.Ct. 348, 352 (1928).

The Court has manifested increasing scrutiny of the boundaries of such delegations. As Justice Scalia recently wrote for the Court in *F.C.C. v. Fox Television Stations, Inc.*:

> If agencies were permitted unbridled discretion, their actions might violate important constitutional principles of separation of powers and checks and balances. To that end the Constitution requires that Congress' delegation of lawmaking power to an agency must be "specific and detailed." *Mistretta v. United States,* 488 U.S. 361, 374, 109 S.Ct. 647, 102 L.Ed.2d 714 (1989). Congress must "clearly delineat[e] the general policy" an agency is to achieve and must specify the "boundaries of [the] delegated authority." *Id.,* at 372–373, 109 S.Ct. 647. Congress must "'lay down by legislative act an intelligible principle,' " and the agency must follow it. *Id.,* at 372, 109 S.Ct. 647 (quoting **537 J.W. Hampton, Jr., & Co. v. United States,* 276 U.S. 394, 409, 48 S.Ct. 348, 72 L.Ed. 624 (1928)).

129 S. Ct. 1800, 1823-24 (2009). [15]

As a result of serial amendments in Sarbanes-Oxley and Dodd-Frank,[16] the SEC has been left with the very "unbridled discretion" condemned by the *Fox Television* Court as offending the separation of powers. Congress delegated this vast and unreviewable authority while providing none of the necessary "specific and detailed" policy boundaries or "extensive procedural safeguards" to guide the Commission's charging decisions. This delegated authority to eradicate citizens' Seventh Amendment rights is unaided by any legislative directive, guide, instruction, or even general principles. Congress having left the Commission with nothing "intelligible" to direct this crucial decision, the SEC's authority is unconstitutional. The continued and knowing

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[15] *See* Stewart & Sunstein, Public Programs and Private Rights, 95 HARV. L.REV. 1193, 1248 (1982) (the APA was a "working compromise, in which broad delegations of discretion were tolerated as long as they were checked by extensive procedural safeguards").

[16] Sarbanes-Oxley Act of 2002, Pub.L. 107–204, 116 Stat. 745; Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub.L. 111–203, 124 Stat. 1376.

exercise of this unconstitutional authority is firmly against public policy, and thus this AP must be dismissed as to Respondents.

The Division Failed to Prove Violations of the
Anti-Fraud Provisions of the Securities Act and Exchange Act

The Division failed to prove all of the elements necessary to establish Respondents' liability under either Section 10(b) of the Exchange Act of 1934 or Section 179A) of the Securities Act of 1933. In short, the Division failed to introduce evidence that the statements in the Private Placement Memoranda ("PPM") and Limited Partnership Agreements were false or misleading at the time they were issued, failed to prove that Respondents were responsible for, or aware of, any false or misleading statements made by others—especially JTF—in connection with the offer and sale of partnership interests in the Funds, and failed to prove that any marketing materials which may have been drafted at some unspecified points by Respondents were indeed shown to or relied upon by investors in connection with the offer or sale of partnership interests in the Funds.

To establish a violation of Section 10(b), the Division was required to prove "(1) a material misrepresentation or materially misleading omission, (2) in connection with the purchase or sale of a security, (3) made with scienter." *See SEC v. Morgan Keegan & Co.*, 678 F.3d 1233, 1244 (11th Cir. 2012); *SEC v. Merch. Capital, LLC*, 483 F.3d 747, 766 (11th Cir. 2007); *see also SEC v. Gann*, 565 F.3d 932, 936 (5th Cir. 2009). To establish a violation under Section 17(a)(1), (2), or (3), the Division had to first prove that JTCM and Jarkesy each made "a material misrepresentation or materially misleading omission," and such misrepresentation and/or omission was "in the offer or sale of a security." *See SEC v. Morgan Keegan & Co.*, 678 F.3d at 1244; *SEC v. Merch Capital,*

LLC, 483 F.3d at 766; *see also SEC v. Spence & Greene Chem. Co.*, 612 F.2d 896, 903 (5th Cir. 1980). Additionally for a claim under Section 17(a)(1), the Division was required to prove that the accused party made the material misrepresentation and/or omission with scienter. *See Morgan Keegan & Co.*, 678 F.3d at 1244; *Merch Capital, LLC*, 483 F.3d at 766. For purposes of securities law, the U.S. Supreme Court has defined "scienter" as "a mental state embracing intent to deceive, manipulate, or defraud." *See Ernst & Ernst v. Hochfelder*, 425 U. S. 185, 194, n. 12, 96 S. Ct. 1375, 1380, 47 L. Ed. 2d 668, 676 (1976); *see also Aaron v. SEC*, 446 U.S. 680, n. 5, 100 S.Ct. 1945, 64 L. Ed. 2d 611 (1980) (applying *Ernst* definition of scienter to Section 17(a)) For violations of Section 17(a)(2) and (3), the Division must prove that the accused party negligently made such material misrepresentations and/or omissions. *See Morgan Keegan & Co.*, 678 F.3d at 1244; *Merch Capital, LLC*, 483 F.3d at 766.

Throughout its Post-Hearing Memorandum, the Division consistently cites statements—in documents and testimony—out of context and omits material information from those sources which define, limit, qualify, or undermine their meaning. Resort to such cherry-picking, while ignoring contravening evidence, allows the Division to paint a materially false or misleading picture of the facts actually adduced at the hearing, eerily similar to the very elements of deceptive conduct the Division has wrongly alleged against Respondents. This is particularly so with the Division's arguments surrounding the PPM and the Limited Partnership Agreements. The offering documents were prepared by qualified securities counsel, and there was *no evidence* introduced at the hearing that the statements made in the offering memoranda were not true at the time the offering documents were prepared. Moreover, the investments in the Funds were sold by an SEC-

registered broker-dealer—not Respondent Jarkesy or JTCM. It was JTF that owed a duty to each of the investors in the offer and sale of the investments in the Funds.

In any event, the claimed "misrepresentations" in the PPM and subscription agreements must be disregarded in their entirety, since *the Division produced no testimonial or documentary evidence that any of the investors even read the document.* Indeed, and incredibly, all of the Division's investor witnesses testified that they never actually read the PPM prior to purchasing interests in the Funds.[17] Thus all of the Division's arguments about the validity of certain PPM statements, materiality, and the applicability of *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S.Ct. 2296 (2011), are inapposite to the analysis of the evidence and must be disregarded. No statements in the PPM or subscription agreements can form the basis for any liability of the Respondents.

The Division places lesser reliance on the "marketing materials" that repeat some of the statements in the PPM, perhaps recognizing that it failed to prove either the provenance of these materials, the timing of their claimed publication, or that any of these documents were actually read by investors prior to their investments in the Funds. The Division has not pointed to any evidence in the record which would support a finding that an actual investor, prior to investing in the Funds, actually read any of these materials, or that the complained-of representations were knowingly—or even negligently—passed on to an investor by another party as a result of the statements in these materials.

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[17] This implausible testimony—including by one investor who is a securities industry professional—would seem to belie the Division's extravagant claim that all of its witnesses testified "credibly and believably."

The Division Failed to Prove Violations of
the Anti-Fraud Provisions of the Advisors Act

Like Sections 17(a) of the Securities Act and 10(b) of the Exchange Act, Section 206 of the Advisers Act, 15 U.S.C. § 80b-6 (2013); 17 C.F.R. § 275.206(4)-8 (2013), prohibits "employing any device, scheme, or artifice to defraud clients or engage in any transaction, practice, or course of business that defrauds clients," but with several differences. *See SEC v. Lauer*, No. 03-80612-CIV, 2008 WL 4372896, at *24 (S.D. Fla. Sept. 24, 2008). First, the Advisers Act is specific to investment advisers. *See id.* Second, Section 206 of the Advisers Act does not require that the alleged violative action occur "in the offer or sale of any" security or "in connection with the purchase or sale of any security." *See id.* (discussing Section 206(1) and (2)); *SEC v. Quan*, No. 11-723 ADM/JSM, 2013 WL 5566252, at *16 (D. Minn. Oct. 8, 2013) (discussing Section 206(4) and Rule 206(4)-8). To establish a violation under Section 206(1), the Division must prove scienter. *See Lauer*, 2008 WL 4372896, at *24, *citing Steadman v. SEC*, 603 F.2d 1126, 1134 (5th Cir. 1979), *aff'd on other grounds*, 101 S.Ct. 999 (1981); *see also Stan D. Kieffer & Assocs.*, Release No. 2023, 77 SEC Docket 679, 2002 WL 442026, at *2 (Mar. 22, 2002). To establish claims under 206(2) and 206(4), the Division must prove negligence at a minimum. *See SEC v. Yorkville Advisors, LLC,* No. 12 Civ. 7728(GBD), 2013 WL 3989054, at *3 (S.D.N.Y. Aug. 2, 2013), *citing SEC v. Moran,* 922 F. Supp. 867, 897 (S.D.N.Y.1996).

In its Post-Hearing Memorandum the Division asserts that the primary "violative conduct" against the proscriptions of the Advisors Act "was Respondents' fraudulent valuation of the Funds' holdings." Yet the Division produced no evidence at the hearing that established that any published valuations, under the valuation discretion conferred

upon the fund Manager, were false. Remarkably, and tellingly, the Division neither designated nor proferred any expert witness who would testify that the valuations in the Spectrum financial statements were false or inflated. None of the Division's lay witnesses were able to supply the missing testimony either. There was no testimony that Respondents misvalued the positions of the Funds in the portfolio companies, and the valuations of the life settlement policies—at a 12% discount rate instead of the Division's preferred 15%—was within the range permitted *according to the Division's own witnesses* and consistent with the considerable discretion afforded to the Manager in the offering documents. There is not one shred of evidence to prove that these valuations were objectively unreasonable. The Division's bootstrapping complaint that the claimed offering fraud—which it failed to prove—also constitutes a violation of the Advisors Act, is creative, but ultimately unavailing.

The Division finally resorts to its unsupported postulation that Respondents violated the Advisors Act by "repeatedly favoring Belesis's and JTF's pecuniary interests over those of the Funds." The only evidence the Division identifies in support of this theory involves the Respondents' alleged "negotiation and/or approving investment banking agreements that paid JTF excessive fees and fees for performing no services." But the evidence adduced at the hearing proved just the opposite: that the fees were consistent with market rates for securing financing for struggling enterprises in the dire financial predicaments faced by the portfolio companies. Once again, the Division was not able to produce any expert in the securities industry who could testify that the fees paid to Belesis were "excessive" under the circumstances faced by the portfolio companies. The Division's *own witnesses* established that JTF was the only brokerage

firm which would—for any price—attempt to raise the financing those companies so desperately needed. The evidence also demonstrated amply that Respondent Jarkesy "favored" Belesis to the extent necessary to maintain the relationship among the Funds, the portfolio companies, and JTF, all *for the benefit of the Funds*. There was no evidence introduced to controvert Jarkesy's testimony that all of the measures taken to placate Belesis were intended to, and did, benefit the Funds by keeping the portfolio companies afloat.

The Division cannot prove *scienter*. Investing his life savings into the venture not only gave Mr. Jarkesy "skin in the game," it negates any inference of *scienter*. When considering the Division's theory of *scienter* and the applicable standard of proof, it is impossible to conclude that—with so much "skin in the game"—someone would invest his life savings into a venture and then engage in severely reckless or event negligent conduct. Other evidence refutes a finding of *scienter*. No one would invest their life savings into a venture and then withhold his best judgment and efforts. At all times, Respondents acted in good faith to make the Funds succeed. If the business plan became impossible to achieve due to the market crash, that does not constitute fraud. The Division wholly failed to prove a violation of the Advisors Act.

The Division Failed to Prove Aiding and Abetting Liability for Respondents Under Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10(b)-5

In addition to claiming primary liability under Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, the Division asserts aiding and abetting liability against both Respondents. To establish aiding and abetting liability, the Division must prove "(1) the existence of a securities law violation by the primary (as opposed to the

aiding and abetting) party; (2) knowledge of this violation on the part of the aider and abettor; and (3) 'substantial assistance' by the aider and abettor in the achievement of the primary violation." *SEC v. Apuzzo*, 689 F.3d 204, 211 (2d Cir. 2012) (discussing aiding and abetting claims under Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10(b)-5); *SEC v. DiBella*, 587 F.3d 553, 566 (2d Cir. 2009) (same).

As discussed above, The offering documents were prepared by qualified securities counsel, and there was *no evidence* introduced at the hearing that the statements made in the offering memoranda were not true at the time the offering documents were prepared. The Offering documents adequately disclosed the terms of the offering, risks and contingencies. The Division failed to prove that the provisions of the offering document were false at the time they were made. The offering documents permitted flexibility in changing the business plan because of the need to adjust to unexpected circumstances. For example, the economic downturn—or market crash—of 2008 and 2009 was impossible to predict, and caused a need to adjust the strategy just to survive. Penalizing a fund manager for adjusting a business plan in the wake of an economic crash is both inequitable and against public policy. Moreover, the investments in the Funds were sold by an SEC-registered broker-dealer—not Respondents. Each of the investors called by the Division was a client of JTF and received most of their information through JTF. It was JTF that owed a duty to each of the investors in the offer and sale of the investments in the Funds.

Because the Division failed to prove the existence of a securities law violation by the primary (the Funds), the Division cannot establish the remaining two elements for aiding and abetting liability.

Imposition of Remedies is Not Supported by Evidence or Public Policy

Because the Division failed to prove its case against Respondents, no sanctions may be imposed. But even if the Division had succeeded in establishing liability under any of its theories, it would have faced considerable obstacles in arguing for the imposition of statutory remedies.

First, the Division provided no evidence to show exactly *when* any of the investors actually purchased their partnership interests—making it impossible to determine which investors' funds were tendered within the limitations period, and—for penalty purposes—subsequent to the effective date of Dodd-Frank. Second, out of the ninety or so investors over the six-year period from 2007 to 2012, the Division offered only a cherry-picked handful as witnesses. Thus, even cast in the most favorable light for the Division, the evidence did not establish that any misrepresentations were published to the vast majority of investors. Third, the evidence established that the losses to date experienced by investors—including Mr. Jarkesy—were caused by the failure of the portfolio companies to thrive—not by misconduct on the part of Mr. Jarkesy or the management of the portfolio companies. The Funds took more than 60 positions, many of which were successful. There was absolutely no evidence introduced from which to ascertain that any of the alleged conduct caused losses in the Funds' accounts. As this Hearing Officer has recognized, any disgorgement must be calculated from "profits causally connected to the violation." *See Gerasimowicz*, 2013 SEC LEXIS 2019*6

(Initial Decision July 12, 2013). The Respondents indeed *lost* money in the Funds, and thus there would be no "profits" to disgorge, but even if there were, the Division failed to establish—and indeed cannot point to any evidence in support—what monies were wrongfully obtained by Respondents that were causally connected to the alleged conduct.

The failure of proof regarding timing and amounts of investments from most, if not all, of the Fund partners precludes the imposition of penalties. The Dodd-Frank Wall Street Reform and Consumer Protection Act purportedly allows the Commission to seek penalties in administrative hearing. But Dodd Frank's effective date was July 21, 2010. *See Weller v. HSBC Mort. Servs., Inc.*, --- F. Supp. 2d ----, 2013 WL 4882758, at * 3 (D. Colo. Sept. 11, 2013). Many of the actions taken by Respondents of which the Division complains, and seeks penalties, happened prior to the effective date of Dodd-Frank which may not be applied retroactively. *See Henning v. Wachovia Mortg.*, --- F. Supp. 2d ----, 2013 WL 5229837, at * 5 (D. Mass. Sept. 17, 2013) (providing a list of cases ruling that the provisions of Dodd-Frank do not provide for retroactive application). The Division failed to prove the causally-connected investments that post-dated Dodd-Frank's effective date in mid-2010, and for that reason alone there is no basis for the imposition of penalties.

The remedies sought by the Division are out of line with comparable cases and, in fact, are harsher sanctions than those imposed against some of the Enron defendants. As against Respondents, the Division seeks $1,560,000 in disgorgement, a penalty exceeding $15,000,000 for Mr. Jarkesy, and a penalty exceeding $74,000,000 for the Adviser, for a total of more than $90,000,000. This is outrageous for Funds that raised about $23 million, are not a total loss, and where there is no allegation of misappropriation of client

funds. Mr. Jarkesy lost money on the venture after subtracting the more than $600,000 he personally put into the Funds, including his initial investment and the amounts he tendered later to keep the Funds going. Moreover, the Division has not submitted proof as to the amount Mr. Jarkesy personally received, if any, from the fees paid by the Funds to the Adviser. Accordingly, no disgorgement is appropriate as to Mr. Jarkesy. The fees paid by the Funds to the Adviser were used by the Adviser for legal fees for advice to the Funds and transaction work for positions taken by the Funds, fees of the Fund administrator, audit fees, office rent, salaries to other employees and travel expenses. Contrary to the Division's assertions, the Funds were not a fraudulent enterprise. In fact, the Division has only made allegations as to three equity positions and the life settlement policies. The Funds took numerous other positions, some of which were profitable investments. And the losses to the Funds were not caused by the conduct alleged by the Division. It is, therefore, inappropriate to order disgorgement of monies for which value was given. In addition, the Division seeks lifetime securities industry and officer and director bars.

When comparing even to the co-respondents in the instant case, Belesis and JTF, Belesis was sanctioned with ***one year*** bars for ***each*** the three bars (securities industry, penny stock and officer or director of public companies) for which the Division seeks lifetime bars from Respondents. Then, Belesis was ordered to pay $311,948 in disgorgement with prejudgment interest of $88,052, and a civil money penalty in the amount of $100,000. JTF was ordered to pay only a civil money penalty of $500,000 over the course of a year. Thus, after making $8 million from a so-called fraudulent enterprise, while JTF was an SEC-registered broker-dealer and and Belesis was a

registered securities professional, they were ordered to repay $1/8^{th}$ of what they made.

Even if the Court finds there were violations, the requested penalties are grossly out of proportion to the alleged misconduct, especially when considering the conduct of the settling respondents in this case.

Conclusion

Numerous of the Commission's actions have rendered this proceeding void and it should be dismissed. In addition, the Division failed to establish the allegations in the OIP and failed to prove the alleged statutory violations. For all of these reasons, this proceeding should be dismissed as to Respondents. Moreover, in the event the ALJ finds that a violation occurred, there were no ill-gotten gains, and the Division has failed to adduce evidence reflecting the timing of the alleged violations such that a penalty can be fixed for conduct occurring after the effectiveness of Dodd-Frank.

Respectfully Submitted,

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