UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-20531

In the Matter of **Horter Investment Management, LLC and Drew K. Horter,** **Respondents.**	**Judge Carol Fox Foelak**

DIVISION OF ENFORCEMENT'S MOTION FOR SANCTIONS AGAINST RESPONDENTS

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INTRODUCTION

Respondents Horter Investment Management, LLC ("HIM") and Drew K. Horter ("Horter") concede that they failed reasonably to supervise, within the meaning of Section 203(e)(6) and (f) of the Investment Advisers Act of 1940 ("Advisers Act"), Kimm Hannan ("Hannan"), a former HIM Investment Adviser Representative ("IAR") who fraudulently misappropriated $728,001 of HIM client assets in violation of Section 206(1) and (2) of the Advisers Act and is now serving a 20-year term of imprisonment. (*See* Order Making Findings and Imposing a Cease-and-Desist Order and Ordering Continuation of Proceedings, Rel. No. IA-6182, 2022 WL 16709988 (Nov. 3, 2022) (hereinafter "Consent Order").) Specifically, in failing to supervise Hannan, HIM and Horter were aware that Hannan was engaged in outside business activities through his entities Hannan Properties, LLC and HR Resources, LLC, yet HIM processed and executed 17 requests by Hannan to distribute nearly three-quarters of a million dollars of HIM clients' funds to Hannan Properties, thereby facilitating Hannan's fraudulent solicitation and receipt of HIM client funds. (Consent Order ¶¶ 18-21.) Respondent HIM also concedes it willfully violated Section 206(4) of the Advisers Act, and Rule 206(4)-7 thereunder, by failing to adopt and implement policies and procedures reasonably designed to prevent violations, by HIM and its supervised persons, of the Advisers Act and the Commission's rules. (*Id*. ¶¶ 85-86.)

In light of these serious, repeated violations and to protect the public, the Division of Enforcement ("Division") requests that the Hearing Officer impose civil penalties on HIM and Horter, place limitations on Horter's activities, and censure HIM pursuant to Section 203 of the Advisers Act. Specifically, the Division requests that the Hearing Officer order HIM and Horter to pay civil penalties of $250,000 and $125,000, respectively, bar Horter from association in a

supervisory capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization with a right to reapply after a period of two years, and censure HIM.

Respondents' violations are undisputed and egregious. HIM and Horter knew, or should have known, that Hannan was soliciting HIM client funds for his outside business activities. Nevertheless, neither HIM nor Horter reasonably supervised Hannan's activities. Indeed, HIM processed 17 client distributions to Hannan Properties, which Hannan ultimately used to gamble, pay personal expenses, and repay other investors in violation of the Advisers Act. In addition, HIM and Horter neglected their critical duties as a registered investment adviser and supervisor, respectively, to reasonably supervise Hannan and other IARs and prevent them from violating the Advisers Act. Finally, HIM willfully failed to adopt and implement policies and procedures concerning third-party distributions and other matters reasonably designed to prevent Hannan's repeated violations of the Advisers Act. For these and the other reasons set forth below, the requested civil penalties, bar, and censure are in the public interest.

PROCEDURAL BACKGROUND

On September 8, 2021, the United States Securities and Exchange Commission ("Commission") filed an Order Instituting Proceedings ("OIP") against HIM and Horter. The OIP alleged that HIM, a registered investment adviser, and Horter, HIM's founder and CEO, failed reasonably to supervise Hannan, a HIM IAR who, from November 2015 to March 2107, misappropriated $728,001 from HIM clients purportedly for his outside business activities ("OBA"). As alleged in the OIP, HIM failed to establish supervisory policies and procedures, failed to follow those policies and procedures it had in place, and failed reasonably to follow up on red flags. Similarly, Horter, who had overall supervisory responsibility for HIM, failed to

follow specific policies and procedures, failed reasonably to supervise Hannan, made open-ended delegations of supervisory responsibility without following up, and failed reasonably to follow up on red flags. (OIP ¶¶ 1-3.)

On September 22, 2022, HIM and Horter submitted an offer of settlement, which the Commission determined to accept. (Consent Order at 1). In the Consent Order, the Commission required HIM to cease and desist from committing or causing any violation and any future violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder. (*Id.* at 13). The Consent Order also specified that HIM and Horter agreed to continued proceedings to determine (a) what, if any, civil penalties are appropriate and in the public interest under Section 203(i) of the Advisers Act, and (b) what, if any, other remedial actions are appropriate and in the public interest under Section 203(e) and (f) of the Advisers Act, and that, in connection with those proceedings, the findings of the Consent Order "shall be accepted and deemed true by the hearing officer." (*Id*.)

STATEMENT OF FACTS

I. HIM Hires Hannan as an IAR.

HIM is an investment adviser that has been registered with the Commission since January 2007. Horter is HIM's founder and, at all times relevant to the conduct at issue, was HIM's President, Chief Executive Officer, and Managing Member. (Consent Order ¶¶ 5-6.) Hannan was an IAR with HIM from December 1, 2014 through March 24, 2017, and during the time he was associated with HIM, Hannan worked from a remote office location. (*Id*. ¶ 7.)

Immediately prior to joining HIM, Hannan voluntarily terminated his employment with another investment adviser on October 22, 2014, following an internal review. A Form U5 filed on November 14, 2014 confirmed the basis for Hannan's termination was his "use of marketing materials not approved by the firm and that checks were made payable to his DBA, rather than

his RIA as required." (*Id*. ¶ 13.) On November 21, 2014, Hannan signed an IAR agreement with HIM and, on December 1, 2014, Hannan registered with HIM. (*Id*. ¶ 14.)

The day after Hannan registered with HIM, the Financial Industry Regulatory Authority ("FINRA") sent Hannan a letter informing him it was initiating an inquiry regarding his conduct at his prior investment adviser. A week later, Hannan forwarded the FINRA letter to a HIM compliance officer (the "Compliance Officer"). (Consent Order ¶ 15.) After reviewing the FINRA letter, the Compliance Officer recommended to Horter that he fire Hannan for effectively failing HIM's due diligence process. Horter rejected the Compliance Officer's recommendation and instructed the Compliance Officer to ask Hannan for an explanation of the conduct FINRA was investigating, which he did. Horter subsequently accepted Hannan's self-serving explanation without question or any further investigation of Hannan, FINRA, or anyone else. As a result, HIM and Horter failed reasonable to investigate the conduct identified by FINRA or to follow up on the FINRA inquiry. (*Id*. ¶ 16.)

HIM designated Hannan a high-risk adviser, but subjected him to no specific restrictions, requirements, or heightened supervision as a result of the designation. Hannan continued as an IAR with HIM until his employment was terminated on March 24, 2017. (*Id*. ¶ 17.)

II. Horter's Supervisory Responsibilities.

A. Horter was a Supervisor for HIM Generally and for Hannan Specifically.

Horter had ultimate supervisory responsibility for HIM's policies and procedures and overall supervisory responsibility for HIM and its IARs generally and Hannan specifically. (Consent Order ¶¶ 10, 14.) Horter also had final authority to hire, fire, or discipline HIM's IARs, including Hannan. (*Id*. ¶ 10.)

B. Horter Unreasonably Delegated Supervisory Responsibility.

Horter purported to delegate supervisory responsibilities, but those delegations were *ad hoc* with no documentation evidencing the delegations or defining their nature and scope. Horter failed to follow up on or oversee his delegations of supervisory responsibility. (Consent Order ¶ 11.) For example, Horter delegated responsibility to the Compliance Officer for the required annual review of HIM's policies and procedures in 2016 and 2017 and to both a consulting firm and the Compliance Officer for the 2015 annual review, but did nothing to oversee those delegations or supervise the reviews. (*Id*. ¶ 12.)

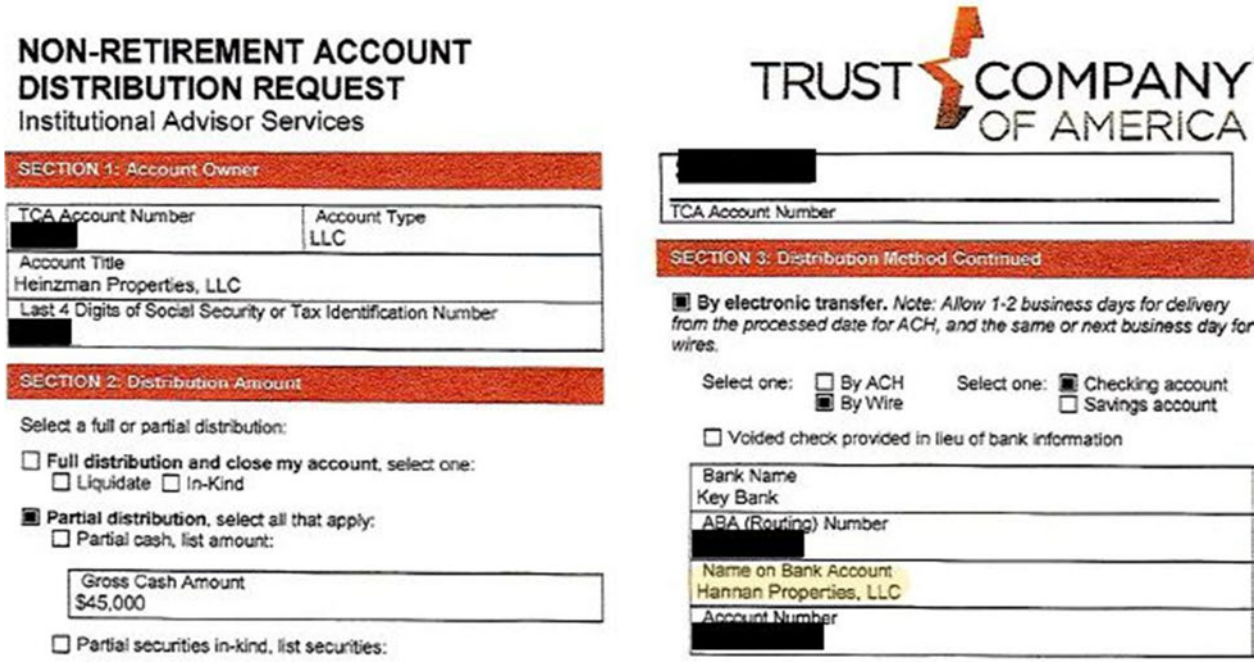
Horter delegated supervisory responsibility for individual HIM policies and procedures in a similar manner; Horter did not confirm whether his delegatee was following HIM's specific policies and procedures and was not aware of any problems or issues unless the delegatee raised them. (*Id*. ¶ 80-85.) Horter could not recall anything specifically he did to oversee his delegation of supervisory responsibility to HIM's compliance department to ensure it was adequately supervising Hannan, and Horter did not recall working with compliance regarding Hannan. (*Id*. ¶ 84.) According David E. Paulukaitis, the Division's expert witness, Horter's failure to take any steps to satisfy himself that Hannan's supervision was being conducted in an adequate and reasonable manner was unreasonable. (Ex. A, Expert Report of David E. Paulukaitis ("Division Expert Report"), at 25 (June 17, 2022).)

III. Hannan Solicited and Received $728,001 from HIM Clients for his Outside Business Activities.

Hannan Properties, LLC ("Hannan Properties") was an outside business activity ("OBA") of Hannan's known to Horter and HIM as a result of their onboarding of Hannan. (Consent Order ¶¶ 18-19.) As a result of Hannan's repeated submissions of third-party distribution requests to HIM for distributions from his clients to Hannan Properties, HIM was aware Hannan

continued to operate Hannan Properties during his tenure at HIM. (*Id*. ¶ 19.) As early as fall 2016, Horter and HIM were aware of HR Resources, LLC ("HR Resources"), another OBA of Hannan's for which he solicited and received funds from HIM clients. (*Id*.)

Between November 19, 2015 and March 8, 2017, Hannan solicited and received distributions to Hannan Properties totaling $728,001 from the accounts of several HIM clients. (*Id*. ¶ 20.) To receive those funds, Hannan submitted to HIM 17 requests to distribute HIM client funds to Hannan Properties, which the firm processed and executed. Each of those third-party distribution requests clearly listed Hannan Properties as the recipient of the transferred client funds. (*Id*. ¶ 21.) For example:



NON-RETIREMENT ACCOUNT DISTRIBUTION REQUEST
Institutional Advisor Services

TRUST COMPANY OF AMERICA

SECTION 1: Account Owner

TCA Account Number [redacted]	Account Type LLC
Account Title Heinzman Properties, LLC	
Last 4 Digits of Social Security or Tax Identification Number [redacted]	

SECTION 2: Distribution Amount

Select a full or partial distribution:

☐ **Full distribution and close my account**, select one:
☐ Liquidate ☐ In-Kind

■ **Partial distribution**, select all that apply:
☐ Partial cash, list amount:

Gross Cash Amount
$45,000

☐ Partial securities in-kind, list securities:

[redacted]
TCA Account Number

SECTION 3: Distribution Method Continued

■ **By electronic transfer.** *Note: Allow 1-2 business days for delivery from the processed date for ACH, and the same or next business day for wires.*

Select one: ☐ By ACH ■ By Wire
Select one: ■ Checking account ☐ Savings account

☐ Voided check provided in lieu of bank information

Bank Name Key Bank
ABA (Routing) Number [redacted]
Name on Bank Account Hannan Properties, LLC
Account Number [redacted]

(*See* Decl. Ex. 2, Feb. 27, 2017 Heinzman Third-Party Distribution, attached to Declaration of Nicholas Magina filed contemporaneously herewith.) As a result, HIM knew, or should have known, Hannan was soliciting client funds for his OBA. (Consent Order ¶¶ 21, 59.)

Hannan began emailing Horter about HR Resources in October 2016 and solicited Horter to invest in HR Resources beginning in November 2016, seeking as much as $250,000. During

and after that time, there were numerous communications about the business among Hannan, Horter, and the Compliance Officer, including exchanges regarding HR Resources' business model, business plan, and projections. Hannan even offered Horter an ownership interest in HR Resources, proposing Horter invest between $125,000 and $146,000 in return for "10% permanent equity in HR Resources[.]" (*Id*. ¶ 22.) In mid-December 2016, Hannan emailed Horter and explained, "I believe the money issue got in the way to beginning this relationship with Horter [Investment]. I have taken it off the table and will find it elsewhere." (*Id*. ¶ 23.) Despite Hannan's warning that he would find money for HR Resources elsewhere, neither HIM nor Horter ever investigated or even inquired whether Hannan was soliciting HIM clients to invest in HR Resources. (*Id*. ¶ 24.)

On or about March 17, 2017, HIM initiated an internal investigation after staff responsible for processing third-party distributions alerted HIM's Compliance Officer that she was having a problem processing a distribution from a HIM client to one of Hannan's OBAs. That investigation concluded Hannan violated investment related statutes, regulations, rules, or industry codes of conduct. HIM terminated Hannan's employment on March 24, 2017. (*Id*. ¶¶ 25-26.)

IV. Hannan's Solicitation and Receipt of HIM Client Funds Constitutes Securities Fraud.

As an IAR, Hannan owed a fiduciary duty and duty of undivided loyalty to his HIM clients, including a duty to disclose material information to his clients, and to make his statements concerning proposed investment opportunities true and not misleading. Further, Hannan had a duty not to engage in activity that conflicted with his clients' interest without their informed consent. (Consent Order ¶ 27.)

Hannan made materially false and/or misleading statements and omissions to his HIM clients to persuade them to transfer funds from their HIM accounts to Hannan Properties, an entity under his control and one of his OBAs. These materially false and/or misleading statements and omissions included:

- misrepresenting the state of the businesses for which he was soliciting their funds, including misrepresenting those businesses were doing well;
- failing to disclose those businesses had generated little or no profit, could not make payroll, and were encumbered by debt;
- failing to disclose that he used funds provided by clients for a variety of expenses unrelated to the businesses, including: gambling; alimony and support payments for his ex-wife; personal credit card bills; rent on the building for his investment advisory services business; his utilities; and his car payment and insurance; and
- failing to disclose their funds were used, in part, to pay prior investors rather than for the businesses themselves.

(*Id*. ¶ 28.)

At the time Hannan made these materially false and misleading statements and omissions, he knew, or was reckless or negligent in not knowing, that these statements were materially false and omitted to state material facts necessary to make these statements not misleading under the circumstances. Further, Hannan knew, or was reckless or negligent in not knowing of these disclosure failures to his HIM clients. (*Id*. ¶ 29.) Further, Hannan's materially false and/or misleading statements to investors were important in their decision whether to invest and that had Hannan disclosed those true uses of funds to his HIM clients, they would not have provided funds to him. Finally, Hannan used means or instrumentalities of interstate commerce, including email, mail, and interstate wire transfers, to defraud his HIM clients. (*Id*. ¶¶ 30-31.)

In January 2019, following a jury trial, Hannan was convicted of violating various provisions of the Ohio state securities laws arising from his solicitation and receipt of funds from

clients for his OBAs by means of material misrepresentations and omissions. Hannan is currently serving a 20-year prison term at the Lorain Correctional Institution in Grafton, Ohio. (*Id*. ¶ 32.) Among the statutes Hannan was convicted of violating was Ohio Revised Code §1707.44(M)(1)(a)-(b), which provides:

> No investment adviser or investment adviser representative shall do any of the following: (a) Employ any device, scheme, or artifice to defraud any person; (b) Engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person . . .

(*Id*.) To convict Hannan for violating § 1707.44(M)(1)(a)-(b), the jury found that Hannan acted knowingly. (*Id*. ¶ 33.) Section 1707.44(M)(1)(a)-(b) is Ohio's analog to Section 206 of the Advisers Act, which similarly provides:

> It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—(1) to employ any device, scheme, or artifice to defraud any client or (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client . . .

(*Id*. ¶ 34.) Hannan's knowing conduct that was found to have violated §1707.44(M)(1)(a)-(b) constitutes uncharged violations of Section 206(1) and (2) of the Advisers Act. (*Id*. ¶ 35.)

Hannan's uncharged Advisers Act violations were made possible by HIM's and Horter's failures reasonably to supervise Hannan and their failure to safeguard retail investors' assets against misappropriation. (*Id.* ¶ 36.) Specifically, HIM and Horter failed reasonably to supervise Hannan by failing reasonably to: (a) establish supervisory policies and procedures; (b) implement existing policies and procedures; (c) follow up on red flags; and (d) delegate supervisory authority. (*Id*. ¶ 37.)

V. Horter and HIM Failed Reasonably to Establish Supervisory Policies and Procedures.

Horter and HIM failed to adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act in the areas of high-risk advisers heightened supervision, field visits and branch audits of remote IARs, and third-party distribution requests. (Consent Order ¶¶ 38, 50.)

A. High-Risk Advisers and Heightened Supervision.

HIM designated a significant number of IARs working for HIM as high or moderate risk. HIM designated Hannan a high-risk adviser. (*Id*. ¶¶ 17, 39.) In March 2015, a few months after HIM hired Hannan, a consultant warned HIM that "higher risk IAR's (those with previous disclosures and without IAR experience) require a program of closer supervision, particularly during their first years with [HIM]. Currently, no procedures call for such a review." In September 2016, still during Hannan's tenure with, HIM's Compliance Officer similarly warned of the need for HIM to "get our internal heightened supervision program developed." (*Id*. ¶ 40.)

Despite those warnings, Horter and HIM had no policies or procedures for heightened supervision of high-risk advisers like Hannan until March 20, 2017, days before HIM terminated Hannan's employment. HIM and Horter did not adopt a heightened supervision agreement until November 2017, well after Hannan's employment had been terminated. (*Id*. ¶ 41.) Although HIM designated Hannan a high-risk adviser, it subjected Hannan to no specific restrictions, requirements, or heightened supervision as a result of his high-risk designation. (*Id*. ¶ 42.) The failure of HIM and Horter to establish policies and procedures for the supervision of higher risk IARs such as Hannan was unreasonable. (Ex. A, Division Expert Report at 25.)

B. Field Visits and Branch Audits of Remote IARs.

At all times relevant to the conduct at issue, 95% or more of HIM's IARs, including Hannan, worked from remote or field offices. Commission Examination staff warned HIM in a December 2014 deficiency letter that it had failed to conduct supervisory inspections of its IARs' branch offices. In March 2015, an outside consultant similarly recommended to HIM that it "develop a more detailed procedure for supervising the activities of its remote IARs." Despite these warnings, HIM did not adopt or implement any policies or procedures regarding field visits or branch audits of either its high-risk IARs until March 2017 or its IARs generally until November 2017. HIM did not begin conducting field visits or branch audits until August 2017 and never conducted a field visit or branch audit of Hannan or his office. (Consent Order ¶¶ 43-45.) The failure of HIM and Horter to establish policies and procedures for the examination of remote IAR offices such as Hannan's was unreasonable. (Ex. A, Division Expert Report at 25.)

C. Third-Party Distribution Requests.

Prior to June 2016, HIM had no written policies or procedures regarding distributions from its clients to third parties. In 2016, HIM and Horter specifically considered implementing procedures that would have increased scrutiny of third-party distributions or stopped such distributions altogether, but decided against doing so because they would "get too much backlash from advisers . . . ." (Consent Order ¶¶ 46-47.)

Following an incident in which HIM mistakenly distributed more than $300,000 from a client's account to a third-party in response to a fraudulent email, in June 2016 HIM instituted practices requiring that third-party distributions be (1) verbally confirmed with the client by HIM and (2) documented in a log. However, HIM established no further procedures and no written instructions for either its third-party distribution procedures or the third-party-distribution log.

The new practices were miscommunicated or misinterpreted, not consistently followed, and not monitored by HIM's compliance department or its management, including Horter. (*Id*. ¶¶ 48-49.) HIM did not adopt written policies and procedures for third-party distributions until October 2017, eight months after Hannan was terminated, and the Compliance Officer did not begin monitoring compliance with HIM's third-party distribution log and procedures until December 2017. (*Id*. ¶ 49.)

The absence of any HIM written policies or procedures for monitoring the disbursement of funds from client accounts to third parties was unreasonable. (Ex. A, Division Expert Report at 24.) Moreover, the informal policies that HIM created in June 2016 were inadequate because they were not clearly defined, the staff were not provided with adequate training, and there was no mechanism to ensure that the policies and procedures were being complied with. (*Id*.)

VI. Horter and HIM Failed Reasonably to Implement Supervisory Policies and Procedures.

Horter and HIM also failed reasonably to implement policies and procedures it had adopted to prevent violations of the Advisers Act with respect to OBAs, supervisory reviews, third-party distributions, and the due diligence review of Hannan. (Consent Order ¶ 50.)

A. Outside Business Activities

HIM's only policy regarding OBAs was in the firm's April 1, 2016 Policies and Procedures Manual, which required that "any business other than an IAR's HIM advisory business[]" (1) be reported; (2) be described in a submission by the IAR on a form provided by HIM; (3) receive prior approval from firm management; and (4) receive sign-off from the Chief Compliance Officer ("CCO"). HIM's OBA policies and procedures also required that (a) firm management and the CCO consider whether a proposed OBA may be viewed by clients, customers, or the public as being part of HIM's advisory business and (b) the firm determine

whether any conditions or limitations should be placed on a proposed OBA, including prohibiting such activity. (*Id*. ¶ 52.)

Notwithstanding the requirement in HIM's policy that IARs get prior approval from management for OBAs and signoff from the CCO, Horter and HIM allowed Hannan to operate HR Resources as an OBA without either. HIM failed to adhere to the requirement in its policy that Hannan submit written notice describing HR Resources as a proposed OBA. Most significantly, though, neither Horter nor HIM followed firm procedures which required them to consider: (1) whether HR Resources might be viewed by clients, customers, or the public as being part of HIM's investment advisory business; and (2) whether such OBA should be restricted or prohibited. (*Id*. ¶ 55.) HIM's and Horter's failure to take action to determine how Hannan planned to take to raise money for HR Resources, including whether he intended to solicit money from HIM clients, was unreasonable. (Ex. A, Division Expert Report, at 25.)

B. Supervisory Review

HIM's policies and procedures provided for supervisory reviews and sanctions for violations of the firm's policies in order to "monitor and ensure the firm's supervision policy is observed, implemented properly and amended or updated as appropriate." Nevertheless, HIM had no formal supervisory review process and the firm has no records that Horter or HIM conducted any supervisory reviews of Hannan. (Consent Order ¶¶ 57-58.)

C. Third-Party Distribution Request Log and Distribution Procedures

As noted above, in June 2016, after HIM learned that it processed the distribution of more than $300,000 from a client's account to a third party based on a fraudulent email, HIM began requiring that third-party distributions be verbally confirmed with the client and documented in a third-party distribution log. (*Id*. ¶ 59.) On June 1, 2016, the Compliance Officer sent an email to

HIM executives in which he explained that "[d]istributions to third parties are the highest risk transaction that our organization faces[]" and that requests for third-party distributions "should never be executed unless verbally confirmed by the client. . . . There will be no exceptions to this requirement." (*Id*. ¶ 60.)

However, on at least one occasion, HIM processed a third-party distribution request from one of HIM clients to Hannan's OBA without speaking to the client as required and may have done so on other occasions. HIM also failed to log at least half a dozen third-party distributions from HIM clients to Hannan Properties as required. (*Id*. ¶¶ 61-62.)

Moreover, the third-party distribution log was intended to be something HIM could audit each month as part of its compliance program; however, no one in HIM's compliance department reviewed the log from its implementation in June 2016 until March 2017. (*Id*. ¶ 63.) Similarly, despite acknowledging HIM began the third-party distribution log "to be able to better watch over third-party distributions[,]" Horter never reviewed or monitored the log, did nothing to ensure the compliance department reviewed or monitored the log, and did not even know where it was kept. Moreover, Horter himself acknowledged that had he reviewed the log, which contained only about 50 entries between June 2016 and March 2017, he would have seen the half dozen distributions from HIM clients to Hannan Properties. (*Id*. ¶ 64.)

The HIM employee responsible for processing third-party distributions was never instructed to watch for any particular types of distributions, such as distributions to an IAR from his or her clients, nor did HIM have any procedures for compliance to be notified of any third-party distributions from a client to an IAR. At no time did HIM inquire of its clients why they were transferring funds to a third party, whether the third-party transferee offered them anything

in return, or if the transferee made any promises to them, even if the transferee was their IAR. (*Id*. ¶¶ 65-66.)

D. Onboarding of Hannan

Although HIM's onboardings of IARs, including due diligence review, typically took 30-45 days, Hannan's onboarding only took 7 days and was one of the fastest onboardings at HIM. (Consent Order ¶¶ 67-68.)

After learning of FINRA's inquiry regarding Hannan, the Compliance Officer suggested to Horter that Hannan may have tried to rush through his onboarding before any disclosures were added to his public disclosure report. (*Id*. ¶ 69.) After the Compliance Officer reviewed an updated IAPD public disclosure report for Hannan, he believed Hannan failed the HIM due diligence process and recommended to Horter that he terminate Hannan. As described above, Horter rejected the recommendation and instead directed the Compliance Officer to get Hannan's explanation of his departure from his prior firm, which Horter accepted without question or any further inquiry. Horter, who is the only person at HIM who could authorize hiring IARs who failed to meet the firm's due diligence standards, made the decision to retain Hannan. (*Id*. ¶¶ 70-72.)

HIM's and Horter's failure to investigate the subject of the FINRA inquiry, which concerned Hannan's conduct at his prior firm, or take steps to determine whether or not Hannan would continue those same activities, through HIM, was unreasonable. (Ex. A, Division Expert Report at 24.)

VII. Horter and HIM Failed to Reasonably Respond to Red Flags Regarding Hannan.

Horter and HIM failed reasonably to follow up on multiple red flags. As described above, Horter and HIM received notification of the FINRA inquiry of Hannan days after Hannan began

at HIM. The Compliance Officer specifically warned Horter that Hannan may have tried to conceal what happened at his prior IAR and retrieved a new IAPD public disclosure report for Hannan, which, according to the Compliance Officer, looked different than the one HIM had reviewed as a part of its due diligence of Hannan. Based on the updated report, the Compliance Officer concluded that Hannan failed HIM's due diligence and recommended to Horter that Hannan be terminated. Horter rejected the Compliance Officer's recommendation, choosing instead to accept Hannan's self-serving explanation with no further inquiry or follow-up. (Consent Order ¶¶ 74-75.)

Horter and HIM ignored another red flag by failing reasonably to monitor Hannan, whom the firm had designated a high-risk adviser. As described above, despite designating Hannan a high-risk adviser, neither Horter nor HIM imposed any restrictions, required any heightened supervision, or did anything to ensure Hannan was monitored more closely than IARs not determined to be high-risk. (*Id*. ¶ 76.)

HIM failed reasonably to follow up on the red flags raised by each of the 17 distribution requests submitted by Hannan for distributions by his clients to his OBA, Hannan Properties. HIM received, processed, and executed those distribution requests, but did nothing beyond confirming the distribution with the client; HIM never inquired or investigated why clients were distributing hundreds of thousands of dollars to their IAR's outside business. Neither Horter nor HIM followed up even when half a dozen of those distributions were logged and purportedly subject to supervisory review. (*Id*. ¶ 77.) HIM's failure to follow up is particularly notable given

that Hannan and Hannan Properties are prominently listed on each applicable log entry:

Horter Investm... Management
Client Distribution Request Log
Third Party Distributions

Date	Client Name	Account #	Adviser	Amount	3rd Party Payee	Processor	Authorization
2/5/17	Michael Maletich	[redacted]	Hannan	$4,746.00	Hannan Properties	Jessica	
2/6/17	Michael Maletich		Hannan	$18,225.00	Hannan Properties	Jessica	
2/9/17	Bence Peterson		B. Gray	$38,000.00	Organic Aloe Vera	Jessica	
3/1/17	Heinzman Properties		Hannan	$45,000.00	Hannan Properties	Jessica	

(*See* Decl. Ex. 3, Excerpt of HIM Client Distribution Request Log at SEC-InvTestimony-000235-Long, attached to Declaration of Nicholas Magina filed contemporaneously herewith.)

Finally, Horter and HIM knew Hannan was aggressively attempting to raise money for HR Resources from sources other than Horter – Hannan had specifically told him – but neither did anything to more closely supervise Hannan or investigate whether he might be soliciting HIM clients for funds for his OBA, which he was. (Consent Order ¶ 78.)

With each of these red flags, Horter and HIM failed reasonably to investigate in order to detect and prevent violations of the federal securities laws. To the contrary, Horter and HIM ignored indications of wrongdoing or the significant potential for wrongdoing, thereby allowing Hannan's misconduct to continue. (*Id.* ¶ 79.)

Based on the foregoing facts, the Division's expert witness concluded that neither HIM nor Horter "established reasonable compliance and supervisory systems or reasonably carried out the compliance and supervisory systems that they did have in supervising Hanann." (Ex. A., Division Expert Report, at 25.)

ARGUMENT

In the November 3, 2022 Consent Order, the Commission sanctioned HIM by ordering it to cease and desist from committing or causing any violation and any future violation of Section

206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder. (Consent Order at 13). The Division now requests that the Hearing Officer impose the additional sanctions by ordering HIM and Horter to pay civil penalties of $250,000 and $125,000, respectively, and barring Horter from association in a supervisory capacity with a right to reapply after a period of two years, and censuring HIM.[1]

To assess whether sanctions are in the public interest, the Commission considers, among other things: "the egregiousness of the [respondent's] actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the [respondent's] assurances against Future violations, the [respondent's] recognition of the wrongful nature of his conduct, and the likelihood that the [respondent's] occupation will present opportunities for future violations." *Schield Management Co.*, Rel. No. 34-53201, 2006 SEC LEXIS 195, at *22-23 (Jan. 31, 2006). The Commission also considers "'the extent to which the sanction will have a deterrent effect." *Id*. The inquiry "into the appropriate sanction to protect the public interest is a flexible one, and no one factor is dispositive." *Conrad P. Seghers*, Rel. No. IA-2656, 2007 SEC LEXIS 2238, at *13 (Sept. 26, 2007), *aff'd*, 548 F.3d 129 (D.C. Cir. 2008).

The Commission has consistently held that "failures to supervise cases are serious violations" because "[s]upervisors are the first line of defense against wrongdoing by their subordinates." *Brown, Collins, Walsh, & Wells*, Rel. No. 34-66752, 2012 SEC LEXIS 1127, at *6 (April 5, 2012). HIM's and Horter's failures to reasonably supervise Hannan from committing securities fraud were egregious, recurrent, and occurred over a period of 17 months. As stated above, HIM and Horter ignored or failed to reasonably address numerous red flags

[1] There is no dispute that HIM is a register investment advisory, Horter was an officer of HIM, they failed reasonably to supervise, within the meaning of Section 203(e)(6) and (f) of the Advisers Act, and HIM willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. (Consent Order ¶¶ 5-6, 85-86.)

regarding Hannan's misconduct. While *scienter* is not a requirement of a failure to supervise charge, the red flags that repeatedly came to HIM's and Horter's attention over this period indicate that HIM and Horter had a high-degree of knowledge or, at a minimum, were extremely reckless. To date, neither HIM nor Horter have offered any assurances against future violations, and continue to vigorously deny any wrongdoing. Moreover, sanctioning HIM and Horter for their supervisory failures will have a strong deterrent effect by signaling to the industry that registered investment advisers and supervisors cannot shirk their supervisory responsibilities by attempting to lay the blame with employees and the wrongdoers. Finally, it would also be in the public interest to sanction HIM for its willful failure to adopt and implement a myriad of polies and procedures, including reasonable third-party distribution procures that would have prevented Hannan's misconduct. Accordingly, significant sanctions are appropriate and in the public interest.

A. Substantial Civil Penalties Are Appropriate for HIM and Horter.

Section 203(i) of the Advisers Act authorizes the Commission to impose civil monetary penalties if the Commission finds that such person or entity has failed reasonably to supervise another person who commits a violation of the federal securities laws if such other person is subject to their supervision. 15 U.S.C. § 80(b)-3(i)(1)(A)(iv). For penalties in the "Third Tier," Advisers Act Section 203(i)(2)(C), for each act or omission by a person or entity that involved "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement," and also "directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act omission," the maximum penalty amount is $100,000 for a natural person and $500,000 for an entity. 15 U.S.C. § 80(b)-3(i)(2)(C). Adjusted for inflation to the time period of the violations

here, the maximum Third Tier penalties are $207,183 and $1,035,909, respectively. *See* https://www.sec.gov/files/civil-penalties-inflation-adjustments_1.pdf. Advisors Act Section 203(i)(3) also states that, in determining whether civil penalties are in the public interest, the Commission may consider: (a) fraud; (b) harm to others; (c) unjust enrichment (taking into account restitution paid); (d) previous violations; (e) deterrence; and (f) such other matters as justice may require. 15 U.S.C. § 80(b)-3(i)(3).

The Division submits that civil penalties of $250,000 and $125,000 for HIM and Horter, respectively, are in the public interest under the circumstances here.

First, it is undisputed that, while supervised by HIM and Horter, Hannan committed federal securities fraud, in violation of Section 206(1) and (2) of the Advisers Act, for 17 months by misappropriating money from HIM clients through third-party distributions approved, processed, and executed by HIM. (Consent Order ¶¶ 27-35.) Third Tier penalties are therefore warranted against HIM and Horter because their supervisory lapses "involved fraud," which the Commission interprets as meaning "allowed and were responsible, in part, for the success and duration of a registered representative's fraudulent misconduct." *George J. Kolar*, Rel. No. 34-46127, 2002 SEC LEXIS 3420, at *23 (June 26, 2002). HIM's and Horter's conduct also involved "reckless disregard of a regulatory requirement," as required for a Third Tier penalty.

Moreover, while HIM's and Horter's failure reasonably to supervise Hannan was very serious and involved fraud, it was also repeated and occurred over a year and a half, while HIM and Horter ignored numerous red flags alerting them to the problem. For example, HIM and Horter ignored the following red flags:

- **Onboarding**. While HIM and Horter received notification of Hannan's FINRA inquiry days after Hannan began at HIM and the Compliance Officer recommended to Horter that Hannan be terminated, Horter instead accepted

Hannan's self-serving explanation with no further inquiry or follow-up (Consent Order ¶¶ 74-75);

- **High-Risk Adviser**. HIM designated Hannan as high risk, but neither HIM nor Horter imposed any restrictions, required any heightened supervision, or did anything to ensure Hannan was monitored more closely than IARs not determined to be high-risk – even though HIM was warned by Examination staff and an outside consultant about the need to develop an effective compliance program and to establish necessary supervisory policies and procedures (*id*. ¶ 76);

- **HIM Approved 17 Distributions to Hannan Properties**. HIM received, processed, and executed each of the 17 distribution requests submitted by Hannan for distributions by his HIM clients to his OBA, Hannan Properties, but did nothing beyond confirming the distribution with the client; HIM never inquired or investigated why clients were distributing hundreds of thousands of dollars to their IAR's outside business and neither Horter nor HIM followed up even when half a dozen of those distributions were logged and purportedly subject to supervisory review (*id*. ¶ 77); and

- **HIM and Horter Knew Hannan Was Aggressively Seeking Investors for HR Resources**. HIM and Horter knew Hannan was aggressively attempting to raise money for HR Resources from sources other than Horter, but neither did anything to more closely supervise Hannan nor investigate whether he might be soliciting HIM clients for funds for his OBA, which he was (*id*. ¶ 78).

Second, HIM's and Horter's failure to reasonably supervise Hannan resulted not just in the risk of substantial losses but in ***actual, substantial losses*** to HIM clients. It is undisputed that HIM processed and approved 17 third-party distributions from HIM clients to Hannan Properties, resulting in HIM client losses of $728,001. (Consent Order ¶ 20.) If HIM had established and implemented policies and procedures to "safeguard client assets from conversion or inappropriate use by advisory personnel" – one of the areas the Commission has identified, at a minimum, should be addressed in an investment advisory firm's written policies and procedures – none of this would have occurred. *See* Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Investment Act Release No. 2204, February 5, 2004, *available at* https://www.sec.gov/rules/final/ia-2204.htm.

Third, while neither HIM nor Horter were unjustly enriched by Hannan's fraud or their failures to reasonably supervise him, they have not reimbursed HIM clients in full for the 17 third-party distributions to Hannan Properties that HIM processed and approved. Three HIM clients requested the 17 distributions in this case, for a total of $728,001. (*See* Chart of HIM Client Distributions to Hannan Properties, Exhibit 1 to Declaration of Nicholas Magina filed contemporaneously herewith.) HIM has only paid these clients $360,000 – less than 50% of their losses from HIM's approving and processing distributions to facilitate Hannan's fraud.[2] (*Id*.)

Finally, substantial civil penalties would send a strong deterrent to investment advisers regarding the need for firms and executives in HIM's and Horter's position to appropriately supervise employees.

Based on their failure to reasonably supervise Hannan from committing fraud, the Division seeks civil penalties of $250,000 and $125,000 against HIM and Horter, respectively. *See Angelica Aguilera*, Rel. No. ID-501, 2013 SEC LEXIS 2195, at *72 (July 31, 2013) (imposing $150,000 Third Tier penalty for failure to supervise, but waived due to inability to pay); *see also Charles L. Rizzo & Gina M. Hornbogen*, Rel. No. 34-67479, 2012 SEC LEXIS 2299, at *25 (July 20, 2012) (investment adviser principal agreed to pay civil penalty of $130,000 for failure to supervise; civil penalty of other principal reduced in light of financial condition); *WestEnd Capital Management, LLC*, Rel. No. IA-3919, 2014 WL 4630277, at *7 (Sept. 17, 2014) (investment adviser agreed to pay $150,000 civil penalty for failure to supervise employee who misappropriated $320,000 from fund); *H.D. Vest Investment Securities, Inc.*, Rel. No. 34-74429, 2015 SEC LEXIS 860, at *19 (Mar. 4, 2015) (broker-dealer agreed to pay

[2] HIM has paid another client $380,500 to settle a lawsuit arising out the Hannan fraud. But none of the payments made by that client to Hannan were routed through HIM or approved and processed through HIM's third-party distribution system. (Declaration of Nicholas Magina ¶ 9, filed contemporaneously herewith.)

$225,000 civil penalty for failure to supervise registered representative who misappropriated $300,000 from brokerage customers).

B. Two-Year Supervisory Bar is Appropriate for Horter.

Section 203(f) of the Advisers Act empowers the Commission to sanction any person associated with an investment adviser, if the person has failed reasonably to supervise, with a view to preventing violations of the federal securities laws, another who commits such a violation, if such other person is subject to his supervision. 15 U.S.C. § 80b-3(f). To assess whether a bar is in the public interest, the Commission considers, among other things: "the egregiousness of the [respondent's] actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the [respondent's] assurances against Future violations, the [respondent's] recognition of the wrongful nature of his conduct, and the likelihood that the [respondent's] occupation will present opportunities for future violations," as well as the "deterrent effect." *Schield Management Co.*, 2006 SEC LEXIS 195, at *22-23

Horter should be barred from association in a supervisory capacity with the right to reapply for association after two years. As described above, Horter's egregious failure to reasonably supervise Hannan, which resulted in fraud and substantial losses to HIM clients, the repeated and prolonged nature of Horter's supervisory failures, and the need to deter others, warrants a two-year supervisory bar for Horter. *See supra* at 20-21.

Moreover, while *scienter* is not a requirement of a failure to supervise charge, Horter's knowledge of numerous red flags indicate that he has a high-degree of knowledge or, at a minimum, was extremely reckless. For example, Horter overrode his Compliance Officer's suggestion to terminate Hannan due to the FINRA inquiry and due diligence failures, and accepted Hannan's self-serving explanation without any investigation. (Consent Order ¶ 16.) As

Hannan's supervisor, Horter should have known that HIM designated Hannan as high risk, yet Horter took no steps to ensure that any heightened supervision occurred. (*Id*. ¶ 17.) Indeed, Horter could not even remember anything he did to oversee his delegation of Hannan's supervisory responsibility to HIM's compliance department. (*Id*. ¶ 84.) Such derelict delegation of supervisory responsibilities is unreasonable under prevailing industry norms and should not be sanctioned. (Ex. A, Division Expert Report, at 25.) *See Rita H. Malm & Robert W. Berg*, Rel. No. 34-35000, 1994 SEC LEXIS 3679, at *23 (Nov. 23, 1994) ("[I]t is not sufficient for the person with overarching supervisory responsibilities to delegate supervisory responsibility to a subordinate, even a capable one, and then simply wash his hands of the matter until a problem is brought to his attention. . . . Implicit is the additional duty to follow-up and review that delegated authority to ensure that it is being properly exercised."). Finally, Horter knew that Hannan was actively soliciting investors in HR Resources and yet did nothing to investigate whether Hannan was soliciting HIM clients, which he was. (Consent Order ¶¶ 22-23; Decl. Ex. 4, Mar. 23, 2017 Email from K. Hannan to D. Horter, *et al.*, HORTER-SEC052338, attached to the Declaration of Nicholas Magina, filed contemporaneously herewith.)

Finally, Horter has not accepted the wrongful nature of his conduct. He fought this administrative proceeding for over a year and has sought to lay blame on everyone but himself, including the employee who logged the third-party distribution requests, was never trained to detect fraud or recognize improper transfers from clients to IARS, and was supervised by nothing more than what amounted to a rubber-stamping process. (Ex. B, Expert Rebuttal Report of David E. Paulukaitis, at 4-5, 16-17 (July 15, 2022).) While it appears that HIM may have already taken steps to remove Horter from his supervisory role and compliance-related duties (Decl. Ex. 5, May 25, 2022 Horter Deposition Transcript at 29:13-20; 30:10-31:2, attached to the

Declaration of Nicholas Magina filed contemporaneously herewith), without a supervisory bar HIM will be able to reverse such restructuring at any time and reinstate Horter has a primary supervisor of IARs.

Accordingly, it is in the public interest to bar Horter from supervisory association the right to reapply after two years. *See Aguilera*, 2013 SEC LEXIS 2195, at *72 (investment adviser President who failed to supervise two IARs who engaged in markup and markdown scheme barred from association in supervisory capacity with broker or dealer); *Charles L. Rizzo*, 2012 SEC LEXIS 2299, at *24 (investment adviser principals who failed to supervise IAR who misappropriate client funds agreed to permanent supervisory bars); *Advanced Prac. Advisors, LLC & Paul C. Spitzer*, Rel. No. IA-5670, 2021 SEC LEXIS 92, at *13 (Jan. 14, 2021) (founder and CEO of investment adviser who failed to supervise IAR, follow up on red flags, and overrode termination recommended by CCO agreed to permanent supervisory bar); *James T. Budden & Alexander W. Budden*, Rel. No. IA-4225, 2015 SEC LEXIS 4231, at *15 (Oct. 13, 2015) (President and VP of investment adviser who failed to supervise CCO and provided no funding, training or resources to support COO role agreed to 3- and 2-year supervisory bars, respectively).

C. Censure is Appropriate for HIM.

Section 203(e) and (f) of the Advisers Act authorizes the Commission to censure any investment adviser, if it finds that such censure is in the public interest and the investment advisor willfully violated the Advisers Act. 15 U.S.C. § 80b-3(e), (f). It is undisputed here at HIM willfully violated Section 206(4) of the Advisers Acts and Rule 206(4)-7 thereunder by failing to adopt and implement policies and procedures reasonably designed to prevent

violations, by HIM and its supervised persons, of the Advisers Act and the Commissions' rules. (Consent Order ¶ 86.)

In light of HIM's willful failure to adopt and implement policies and procedures reasonably designed to prevent Advisers Act violations, a censure is in the public interest. It is undisputed that HIM failed reasonably to establish policies and procedures designed (a) to prevent the misappropriation of client funds by IARS through third-party distribution request, (b) provide heightened supervision to high-risk IARs, and (c) remote IARs and field visits. (Consent Order ¶¶ 38-50.) Similarly, it is undisputed that HIM failed reasonably to implement supervisory policies and procedures concerning third-party distributions, IAR onboarding, IAR outside business activities, and supervisory reviews (*id.* ¶¶ 51-72), or to follow up on numerous red flags (*id*. ¶¶ 73-79.) These failures occurred over a 17-month period and some even occurred ***after*** HIM was directed to develop and implement these policies and procedures by an independent consultant and Commission staff. (*Id*. ¶¶ 39-45.) Accordingly, HIM did not establish reasonable compliance and supervisory systems or reasonably carry out the compliance and supervisory systems that they did have in supervising Hanann." (Ex. A., Division Expert Report, at 25.) Under these circumstances, a censure of HIM is in the public interest. *H.D. Vest Investment Securities, Inc.*, 2015 SEC LEXIS 860, at *19 (broker-dealer agreed to censure for failing to supervise registered representative who misappropriated $300,000 from brokerage customers).

CONCLUSION

In sum, HIM and Horter failed reasonably to supervise Hannan, within the meaning of Section 203(e)(6) and (f) of the Advisers Act, and HIM willfully violated Section 206(4) of the Advisers Act, and Rule 206(4)-7 thereunder, by failing to adopt and implement policies and procedures reasonably designed to prevent Advisers Act violations, and their egregious conduct

readily establishes that the sanctions requested by the Division are in the public interest. Accordingly, the Division respectfully requests that its motion be granted and that the Court (a) impose civil penalties of $250,000 and $125,000 against HIM and Horter, respectively, (b) bar Horter from association in a supervisory capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, with the right to reapply after a period of two years, and (c) censure HIM.

Dated: January 9, 2023

Respectfully submitted,

/s/ Alyssa A. Qualls

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-20531

In the Matter of **HIM Management, LLC and Drew K. Horter,** **Respondents.**	**CERTIFICATE OF SERVICE**

I hereby certify that I caused a true copy of the foregoing Division of Enforcement's Motion for Sanctions against Respondents to be served on the following on this 9th day of January, 2023, in the manner indicated below:

BY EMAIL
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Dated: January 9, 2023

/s/ Alyssa A. Qualls
Alyssa A. Qualls

EXHIBIT A

Expert Report

David E. Paulukaitis, Managing Director
Mainstay Capital Markets Consultants, Inc.

In the Matter of Horter Investment Management, LLC
and
Drew K. Horter

United States Securities and Exchange Commission
Administrative Proceeding
File No. 3-20531

June 17, 2022

My name is David E. Paulukaitis and I am a Managing Director with Mainstay Capital Markets Consultants, Inc. ("Mainstay"), located at 6600 Peachtree Dunwoody Road, Building 600, Suite 575, Atlanta, Georgia, 30328. I have been retained by the Division of Enforcement of the U.S. Securities and Exchange Commission (the "Division") to provide expert testimony in conjunction with the administrative proceeding initiated by the Division against Horter Investment Management, LLC ("HIM") and Drew K. Horter ("Horter").

Summary of Retention

On September 8, 2021, the Division filed an *Order Instituting Administrative and Cease and Desist Proceedings* (the "*Order*") against HIM and Horter alleging that they violated Section 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act") and Rule 206(4)-7 thereunder as a result of failing reasonably to supervise the activities of a former HIM investment adviser representative named Kimm Hannan ("Hannan"). Hannan, who was associated with HIM from December 2014 until April 2017, was criminally convicted of theft and securities-related fraud for stealing $1.6 million from a number of individuals, including more than $700,000 from his HIM clients. He was sentenced to 20 years in prison and is currently incarcerated.

I have been retained by the Division in this matter to offer opinions regarding the supervisory obligations of HIM and Horter, the adequacy and reasonableness of HIM's compliance and supervisory systems, and whether those compliance and supervisory systems were reasonably carried out relating to the supervision of Hannan's activities.

Qualifications

Mainstay provides compliance consulting services to securities broker-dealers and registered investment advisers. In my capacity with Mainstay, I provide a variety of consulting services focusing on regulatory compliance in the areas of supervision, supervisory controls, and internal compliance systems. I additionally provide consulting services regarding a variety of other areas such as research, investment banking, anti-money laundering ("AML"), general sales practices, and responding to regulatory inquiries, investigations, and enforcement proceedings. The services that I provide are intended to assist

broker-dealers and registered investment advisers in understanding and complying with the rules and regulations promulgated by the SEC and the Financial Industry Regulatory Authority ("FINRA").[1]

In addition to providing compliance consulting services to broker-dealers and registered investment advisers, I have provided consulting services to state securities regulatory authorities and the SEC in support of their investigative and enforcement programs. I have also served as an independent consultant in conducting compliance undertakings mandated under regulatory enforcement proceedings against broker-dealers initiated by the SEC, FINRA, and state regulatory organizations.

Aside from the consulting services that I provide, I am frequently retained as an expert witness in securities arbitrations and litigation. I have also served as an expert witness in conjunction with various regulatory administrative proceedings, both on behalf of regulatory agencies and on behalf of Respondents. I have testified in arbitration hearings, in court proceedings, and in administrative proceedings approximately 200 times.

In addition to my role with Mainstay, I am a Managing Member and co-owner of Advisory Services Network, LLC ("ASN"). ASN, which is an affiliate of Mainstay, is an SEC-registered investment advisory firm established in 2009 that provides investment advisory services to investors through a network of independent investment adviser representatives ("IARs") located across the United States. ASN's IARs currently manage more than $5 billion in client assets.[2]

As a Managing Member of ASN, I am responsible for risk management, including monitoring transactions in client accounts, monitoring the movement of funds and securities into and out of client accounts, and identifying and addressing potential conflicts of interest. I work closely with ASN's Chief

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[1] FINRA is a "self-regulatory organization" responsible for regulating the activities of securities brokerage firms and their representatives. FINRA's activities are overseen by the SEC.

[2] I am individually registered as an investment adviser representative (Series 65) through ASN. My Investment Adviser Registration Depository ("IARD") number is 729689.

Compliance Officer and with the other co-owner of ASN in managing the activities of ASN on a daily basis.

A copy of my curriculum vitae is attached as Exhibit 1.

Prior to my association with Mainstay and ASN, I was employed for 23 years with the National Association of Securities Dealers, Inc. ("NASD"), the predecessor of FINRA.[3] Like FINRA, NASD was responsible for regulating the activities of broker-dealers. As more fully described in Exhibit 2, I was employed as an Examiner, a Supervisor of Examiners, and an Associate District Director in NASD's Atlanta District Office and was directly involved in reviewing the compliance of broker-dealers and their registered representatives with applicable securities industry rules and regulations.

During my NASD career I testified as a staff witness in numerous disciplinary hearings. Those matters dealt with a wide variety of regulatory compliance issues, most of which centered on sales practices and supervision. Those matters involving supervision included testifying regarding the adequacy of supervisory systems and procedures and the adequacy of specific supervisory functions performed.

My services in this matter are being billed at $325 per hour, which is my standard billing rate for expert witness services. The opinions expressed in this report are my own and my services are billed regardless of the outcome of this matter.

Information and Documents Reviewed

In conjunction with my engagement in this matter I have reviewed the following documents:

- A copy of the *Order Instituting Administrative and Cease and Desist Proceedings* regarding HIM and Horter filed by the division on September 8, 2021;

[3] FINRA was established in mid-2007 through the combination of NASD and NYSE Regulation, Inc. (the regulatory arm of the New York Stock Exchange).

- A copy of the *Answer and Affirmative Defenses* filed by HIM and Horter on October 6, 2021;
- The transcript of the investigative testimony taken of Hannan by the Ohio Division of Securities on September 27, 2017;
- A copy of the transcript of the deposition of Hannan taken on May 22, 2019 in conjunction with a civil proceeding, *Buddy Scott, et al. v. Horter Investment Management, LLC*;
- A copy of the transcript of the investigative testimony taken of Horter by the Ohio Division of Securities on October 20, 2017;
- A copy of the transcript of the deposition of Horter dated May 6, 2019 in conjunction with the *Scott v. Horter Investment Management, LLC* civil proceeding;
- Copies of the transcripts (and exhibits) of the investigative testimony of Horter taken by the Division on March 4 and 5, 2021;
- A copy of the transcript (and exhibits) of the deposition of Horter taken by the Division on May 25, 2022;
- A copy of the transcript of the deposition of Jason Long ("Long") on May 6, 2019 in conjunction with the *Scott v. Horter Investment Management, LLC* civil proceeding;
- Copies of the transcripts (and exhibits) of the investigative testimony of Jason Long taken by the Division on January 21 and 22, 2021;
- A copy of the transcript (and exhibits) of the investigative testimony of Jessica Vierling taken by the Division on March 18, 2021;
- A copy of the transcript of the deposition of Vierling taken by Horter's counsel on March 29, 2022;
- A copy of the transcript (and exhibits) of the deposition of Kevin Hetzer taken by the Division on February 9, 2022;
- A copy of the *Uniform Termination Notice for Securities industry Registration* ("Form U5") filed by LPL Financial, LLC on behalf of Hannan Termination of Registration dated November 14, 2014;
- A copy of the Investment Adviser Representative Public Disclosure Report for Hannan dated November 21, 2014 (HORTER-SEC000558-000566);
- A copy of the *Uniform Application for Securities Industry Registration* ("Form U4") filed by HIM on behalf of Hannan dated December 1, 2014 (HORTER-SEC000733-000752);
- A copy of the Prospective New Advisor Scorecard prepared when Hannan joined HIM (HORTER-SEC000522);

- A copy of the Form U5 filed by HIM on behalf of Hannan dated April 3, 2017 (SEC-InvTestimony-000097_Long-000103_Long);
- A copy of the *RIA Compliance Program Review Report* prepared by Oyster Consulting, LLC on behalf of HIM dated March 26, 2015 (HORTER-SEC091166-091176);
- Copies of HIM's *Client Distribution Request Logs* prepared by HIM between June 2016 and January 2018 (SEC-InvTestimony-000220_Long-000238_Long);
- Copies of the *Distribution Requests* initiated by Hannan (HORTER-SEC055462, HORTER-SEC042936, HORTER-SEC042937, HORTER-SEC042938, HORTER-SEC051406, HORTER-SEC048594, HORTER-SEC054877, HEINZMAN_001913, HORTER-SEC044920, HORTER-SEC045993, HORTER-SEC027940, HORTER-SEC030103, HORTER-SEC068429 HORTER-SEC067856, HORTER-SECexam000702, HORTER-SEC076962, HORTER-SECexam000902, HORTER-SECexam000905);
- Copies of internal HIM e-mail messages relating to the disbursement of funds from the accounts of various clients of Hannan (HORTER-SEC055579, HORTER-SEC055576, HORTER-SEC044915, HORTER-SEC027939, HORTER-SEC072451, HORTER-SEC047614, HORTER-SECexam000857, HORTER-SEC075020, HORTER-SEC074507, HORTER-SEC075862, HORTER-SEC079766);
- Copies of HIM's *Policies and Procedures Manuals* dated May 1, 2015 (HORTER-SEC044968-045035), April 1, 2016 (HORTER-SEC045074-045139), and November 10, 2016 (HORTER-SEC045217-045282);
- Copies of HIM's *Prospective Advisor Due Diligence Procedures* dated September 20, 2014 (HORTER-SEC019665-019666), January 16, 2017 (HORTER-SEC-2018exam000252-000254), and November 30, 2017 (HORTER-SEC-2019exam-000255-000257);
- Copies of HIM's *New IAR Onboarding Procedures* dated August 14, 2014 (HORTER-SEC-2018exam-000577-000579), February 11, 2015 (HORTER-SEC019525-019528), March 5, 2015 (HORTER-SEC019507-019508), and November 30, 2017 (HORTER-SEC-2018exam-000594); and
- October 14, 2020 e-mail message from counsel for Horter and HIM, Matthew Fornshell, to SEC counsel Jonathan Epstein (SEC-SECCORR-E-0003254-0003255.

Relevant Background Information

The criminal charges brought against Hannan related primarily to his solicitation of individuals to invest monies into business ventures in which he was personally involved. Rather than use those funds as he represented, Hannan used them to pay personal expenses, gamble, and to repay other investors. More than $700,000 of the approximately $1.6 million of investment funds that Hannan obtained were distributed directly from accounts of clients Hannan serviced through HIM. He obtained those funds between 2015 and 2017 by having clients sign *Distribution Request* forms that instructed HIM and its custodian to wire funds to an entity Hannan personally controlled called Hannan Properties, LLC ("Hannan Properties"). Horter was aware of the existence of Hannan Properties at the time Hannan joined HIM.[4]

Summary of Opinions

Based upon the information and evidence that I have thus far been provided, I do not believe that Horter or HIM established reasonable compliance and supervisory systems or reasonably carried out the compliance and supervisory systems that they did have in supervising Hannan. I reached that broad opinion based on what I believe to be a variety of underlying supervisory failures by Horter and HIM, including:

- While Horter and HIM created written compliance policies and procedures as required by Rule 206(4)-7 of the Advisers Act, nothing in those written policies and procedures was designed to prevent adviser representatives like Hannan from gaining access to or misusing client funds. As a result, I believe HIM's written policies and procedures were inadequate.

  In mid-2016, HIM created a *Disbursement Log* on which were recorded certain disbursements from client accounts payable to third-parties.

[4] Hannan Properties was also disclosed as one of Hannan's outside business activities in the Investment Adviser Public Disclosure ("IAPD) system at the time Hannan became associated with HIM. HIM's records reflect that Hannan's IAPD report was reviewed in conjunction with its consideration of registering Hannan with HIM in 2014.

No written policies or procedures were created at that time regarding the use or review of the *Log* and apparently no substantive training was provided to the staff responsible for completing the *Log*. Had entries on the *Log* been appropriately scrutinized and not just simply recorded, it is likely that Hannan's conversion of client funds would have been detected and, consequently, client funds would have been protected.

- The supervisory obligations imposed on investment advisory firms and their principals are aimed at detecting and preventing violations of the Advisers Act. In that regard, the supervisory principals of investment advisory firms are required to respond to indications of the potential for misconduct by their adviser representatives. Horter and HIM were presented with several indications of the potential for misconduct by Hannan but failed to take any steps to address them. Some of those indications of the potential for misconduct included:

    - After Hannan joined HIM, HIM and Horter learned that FINRA had initiated an inquiry into disclosures on the Uniform Termination Notice for Securities Industry Registration ("Form U5") filed on behalf of Hannan by the firm with which he was most recently associated, LPL Financial, LLC ("LPL"). Those disclosures included allegations that Horter had used marketing materials not approved by LPL and that Hannan had deposited certain checks from clients into the bank account of his "dba" entity[5] rather than to the investment advisory firm with which he was associated. Prior to learning of the FINRA inquiry, neither HIM nor Horter had reviewed Hannan's LPL Form U5.

      While Hannan was verbally asked to explain the circumstances associated with the checks made payable to his "dba" entity, no steps were taken by Horter or HIM to independently verify Hannan's explanation. HIM and Horter did not, for example, seek to obtain copies of the communications between Hannan and FINRA. Those communications likely would have

[5] In the securities industry, a "dba" ("doing business as") entity is a legal entity through which an independent contractor representative conducts his/her broker-dealer or investment advisory business.

provided more information regarding the activities that resulted in the Form U5 disclosures and would have confirmed or contradicted the representations Hannan verbally made to HIM.

Hannan was apparently never asked about his alleged use of unapproved marketing materials.

By failing to inquire further into the disclosures on Hannan's LPL Form U5, HIM and Horter were unable to determine whether Hannan's activities should be subject to any heightened supervisory scrutiny.

- When he joined HIM, Hannan disclosed to HIM and Horter that he was involved in various business activities outside the scope of his association with HIM. While Horter recalled that one of those business entities was Hannan Properties, Horter never took steps to determine the nature of the activities of Hannan Properties or Hannan's role with that entity. Hannan Properties was never disclosed on the Uniform Application for Securities Industry Registration or Transfer ("Form U4") Hannan filed through HIM.

  Because no substantive inquiry was apparently made into Hannan's outside business activities, HIM and Horter were unaware of whether any of those outside activities might conflict with Hannan's activities on behalf of HIM or might potentially adversely affect HIM clients.

- In late 2016, Hannan disclosed to HIM and Horter that he had created an entity called HR Resources, LLC ("HR Resources"). Hannan asked HIM, through Horter, to provide financing for HR Resources. When Horter refused to provide that financing, Hannan responded that he would "find it elsewhere." Neither Horter nor HIM took steps to determine where Hannan intended to obtain this financing for HR Resources, particularly whether Hannan intended to obtain that financing from HIM clients.

- In March 2015 an independent compliance consulting firm recommended that HIM develop detailed procedures for, among other things, supervising the activities of adviser representatives in remote locations and imposing heightened supervision on those adviser representatives deemed by HIM to be higher risk. Horter and HIM did not establish such procedures until days before his association with HIM was terminated. And despite identifying Hannan as a higher risk adviser representative, Horter and HIM never imposed any heightened supervision of any kind over him. Indeed, there is apparently no evidence that Horter or HIM supervised Hannan in any manner.

- Horter acknowledged that he was the supervisory principal of HIM ultimately responsible for supervising the activities of HIM and its adviser representatives, including Hannan. While Horter testified that he had delegated certain supervisory functions to other supervisory principals of HIM, there is no evidence that he took any steps to ensure that those delegated supervisory functions were reasonably and adequately performed.

Opinions

Investment Advisers Act of 1940 and the Duty to Supervise

In relevant part, subparagraph (e)(6) of Section 203 of the Investment Advisers Act provides that the SEC is empowered to initiate an enforcement action against a supervisory principal of a registered investment adviser if that person:

> has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this paragraph no person shall be deemed to have failed reasonably to supervise any person, if—
>
> (A) there have been established procedures, and a system for applying such procedures, which would reasonably be

> expected to prevent and detect, insofar as practicable, any such violation by such other person, and
>
> (B) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

To facilitate compliance with Section 203, Rule 206(4)-7 of the Advisers Act requires investment advisory firms to: "Adopt and implement written policies and procedures reasonably designed to prevent violation, by you and your supervised persons, of the Act and the rules that the Commission has adopted under the Act."

When Rule 206(4)-7 was adopted, the SEC provided the following guidance:

> Rule 206(4)-7 does not enumerate specific elements that advisers must include in their policies and procedures. Each adviser should adopt policies and procedures that take into consideration the nature of that firm's operations. The policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred.[6]

As the SEC explained:

> Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks.[7]

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[6] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, SEC Release No. IA-2204, February 5, 2004.

[7] *Id.*

While not dictating the content of an investment adviser's compliance policies and procedures, the SEC did provide a list of areas that it believed, at a minimum, should generally be addressed in an investment advisory firm's written policies and procedures. One of those areas was: "Safeguarding of client assets from conversion or inappropriate use by advisory personnel."[8]

Hannan was able to gain access to funds of HIM clients by having the clients sign *Distribution Request* forms directing that funds be wired to the bank account of Hannan Properties. As described in the SEC's *Order*, prior to June 2016 HIM had no procedures in place to provide for the tracking or review of disbursements from client accounts to the accounts of third parties.

Jason Long ("Long") was HIM's Assistant Chief Compliance Officer when Hannan joined HIM in late 2014 and he was subsequently designated as HIM's Chief Compliance Officer in April 2016. Long testified that when he joined HIM, "third-party distributions was one of the items on my radar."[9] In June 2016, after an incident in which HIM authorized the disbursement of client funds to an unauthorized third-party based on a fraudulent e-mail request, HIM implemented a procedure that required a trading department employee to verbally confirm with clients each request for a disbursement from the client's account when that disbursement was to be made to a third-party. Additionally, Long helped to create a *Client Distribution Request Log* (the "*Log*") on which all third-party disbursements (and related information) were to be recorded as evidence that those disbursements had been verified with clients.[10]

While the verbal verification of third-party disbursements with clients and the creation of the *Log* were intended to be mechanisms to protect clients and HIM from improper disbursements from client accounts, it was not until October 2017, more than six months after Hannan's misconduct was discovered, that HIM created written procedures that detailed how the verification process was to function so that it would be appropriately carried out. Similarly, prior to

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[8] *Id.*

[9] Long investigative testimony, January 22, 2021, page 190. In an e-mail to HIM's adviser representatives that he drafted in June 2016, Long similarly stated: "Distributions to third parties are the highest risk transaction that our organization faces." (Hetzer Deposition Exhibit 3, HIM_SEC062638.004).

[10] *Id.*, page 198.

October 2017 no training was apparently provided to the employee responsible for making verification calls and populating the *Log* to ensure that she understood the purpose of the process and when she should bring particular disbursements to the attention of her superiors. Additionally, prior to October 2017 there were no procedures for confirming that the verification process was being properly carried out. Reasonably designed procedures governing the processing and review of disbursements from client accounts to third-parties could have helped HIM identify instances in which adviser representatives like Hannan were attempting to convert or otherwise misuse client funds.

As a result of the absence of written procedures and training regarding the processing and review of third-party distributions, there was apparent confusion regarding how the *Log* was to be used. Jessica Vierling ("Vierling"), the employee responsible for maintaining the *Log*, testified that when she began using the *Log* she understood that the only disbursements she was to record were third-party distributions made by wire. She stated she was not instructed to add checks and electronic funds disbursements payable to third-parties to the *Log* until March or April of 2017.[11]

Kevin Hetzer ("Hetzer"), who was Vierling's supervisor and whose title was Assistant Director of Operations and Technology, was responsible for approving each entry on the *Log*. He testified that while he knew third-party wires were required to be captured on the *Log*, he did not recall if distributions to third-parties using other methods (for example, checks or electronic funds transfers) were also required to be recorded.[12]

Contrary to the recollections of Vierling and Hetzer, Long testified that his understanding was that from its first use the *Log* was intended to capture all disbursements to third-parties, regardless of the form those disbursements took.[13]

While there was apparent confusion between Vierling, Hetzer and Long as to the kinds of transactions that should have been recorded on the *Log*, all of

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[11] Vierling March 18, 2021 investigative testimony, pages 50-51 and Vierling March 29, 2022 deposition, pages 43, 48-49.

[12] Hetzer deposition, pages 45-46.

[13] Long investigative testimony, January 22, 2021, pages 199 and 219.

the disbursements from client accounts to Hannan Properties were done via wire. Thus, all of those wires issued between when the *Log* was created in June 2016 and when Hannan was terminated in April 2017 should have been recorded. Of the 13 wires issued during that time period, however, only six were actually recorded on the *Log*.

Each entry on the *Log* was signed by Vierling (or the person who verified a disbursement in Vierling's absence) and by Hetzer (or another officer of HIM in his absence). Vierling testified that while Hetzer would ask her if she had confirmed each disbursement request with the appropriate client, she did not believe he actually reviewed the entries on the *Log* before he signed it.[14] Hetzer acknowledged that he asked Vierling to confirm her contact with clients in conjunction with each third-party disbursement recorded on the *Log*. He testified that he did review each entry on the *Log* when Vierling presented it to him but he did not compare that information to any other entries on the *Log* to determine if there were any other issues, such as suspicious payees or distribution patterns. He also testified that he had no recollection of seeing Hannan Properties as a third-party payee on the *Log* even though the *Log* contained a half dozen such entries.[15]

In conjunction with the creation of the *Log* in June 2016, Long told Vierling and Hetzer that one of the benefits of having the *Log* would be that it would provide HIM's compliance department with "something that we can easily audit each month as part of the compliance program."[16] Long testified, however, that HIM's compliance department did not review the *Log* at any time prior to Hannan's termination from HIM in 2017.[17]

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[14] Vierling investigative testimony, pages 64-65 and Vierling deposition, pages 64-65.

[15] Hetzer deposition transcript, pages 59 and 76. In one instance, Hannan sent directly to Hetzer a request for a third-party disbursement from a client's account payable to Hannan Properties. Hetzer forwarded the request to Vierling. (Hetzer Deposition Exhibit 7, HORTER-SEC055520 to HORTER-SEC055521). Hetzer testified that he had no recollection of the disbursement or the communications from Hannan. (Deposition pages 65-66).

[16] Vierling investigative testimony Exhibit 8 (SEC-InvTestimony-000783).

[17] Long investigative testimony, January 22, 2021, page 223 and Vierling deposition, page 65.

Horter testified that he did nothing to confirm that HIM's compliance department reviewed the *Log*. He testified that he never personally reviewed the *Log* and did not know where the *Log* was located.[18] He testified that had he "studied [the *Log*] hard enough" he would have seen the disbursements paid to Hannan Properties.[19]

All of the disbursements at issue in this matter were made payable to Hannan Properties. Vierling testified that she was aware that Hannan Properties was the payee on each disbursement and she noted that clients confirmed their understanding that Hannan Properties was the payee when she would call them to confirm each disbursement. She testified that while in hindsight it was odd that the name of the payee was the same as the name of the client's adviser representative, that fact did not stand out to her at the time.[20]

Vierling testified that she never received any instructions to be alert to suspicious disbursements such as disbursements made payable to adviser representatives of HIM.[21] Hetzer similarly testified that determining whether a disbursement was being made to an entity owned by an adviser representative of HIM was not part of the procedures for processing third-party disbursements.[22] Long acknowledged that he gave Vierling no specific instructions with respect to disbursements made payable to adviser representatives of HIM, noting:

> I just assumed that this was just blatantly obvious common knowledge.
>
> I guess in hindsight I just assumed she would have known that and – and raised the alarm bell, but that – that proved wrong in the end because she didn't.[23]

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[18] Horter investigative testimony, pages 130-131.

[19] *Id.*, page 140.

[20] Vierling investigative testimony, page 53.

[21] Vierling investigative testimony, pages 53-54, and Vierling deposition, page 96.

[22] Hetzer deposition, page 75.

[23] Long investigative testimony, January 22, 2021, pages 226-227.

Had HIM established procedures relating to the processing and supervisory review of disbursements from client accounts to third-parties, including how to identify suspicious or questionable disbursements, and had Vierling (and any other employees involved in the process) been properly trained on how to review those disbursements, it is likely that Hannan's conversion of client funds would have been detected.

Responding to Information and Incidents of Potential Misconduct

The supervisory obligations of an investment adviser include the duty to identify and respond to indications that an adviser representative may be acting in a way that is inconsistent with the Advisers Act. As the SEC has explained:

> Supervisors must respond vigorously to indications of possible wrongdoing. Red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of the federal securities laws. The Commission has consistently stressed the importance of vigilant supervision.[24]

Several incidents came to the attention of HIM and Horter that should have suggested to them that Hannan could be engaged in misconduct. In each instance, HIM and Horter had a duty to adequately investigate those incidents to satisfy themselves that Hannan was not engaged in misconduct. There is no evidence that they did so.

Hannan's LPL Form U5

Shortly after Hannan joined HIM in late 2014, Hannan advised Long that Hannan had received a request from FINRA regarding the disclosures on the Form U5 filed on his behalf by LPL. Long was unaware of those disclosures prior to being advised of the FINRA request, principally because HIM did not routinely review copies of the Forms U5 filed by the prior employers of new

[24] *In the Matter of RhumbLine Advisers and John D. Nelson*, SEC Administrative Proceeding File No. 3-9744, September 29, 1998.

advisory representatives.[25] The review of the Form U5 filed by the former broker-dealer or investment advisory firm of a prospective adviser representative is a common practice in the securities industry[26] and should have been done as part of on-boarding process for new HIM representatives.

The Form U5 filed by LPL on behalf of Hannan noted that "[LPL's] review confirmed the use of marketing materials not approved by the firm and that checks were made payable to Hannan's DBA, rather than his RIA as required."

Long stated that he discussed the FINRA inquiry and the Form U5 disclosures with Hannan and Hannan stated that the checks referenced on the Form U5 were compensation to him for consulting with clients about the best legal structure to use for holding oil and gas investments. Long stated he was told by Hannan that Hannan's manager at LPL had approved this activity but that a new manager concluded that the activity was improper and permitted Hannan to resign as a result.[27] Long stated that he did not take any steps to independently verify the representations made by Hannan.[28]

Horter's recollection regarding the disclosures on Hannan's Form U5 was similar to Long's.[29] Like Long, Horter testified that he took no action to confirm Hannan' s representations and was unaware if Long had taken any additional action.[30] Horter testified that he accepted Hannan's explanation without further inquiry because he found it to be "plausible."[31]

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[25] Long investigative testimony, January 21, 2021, page 116. LPL filed the Form U5 on behalf of Hannan on November 14, 2014, more than two weeks before HIM's filing of a Form U4 on December 1, 2014 to register Hannan with HIM.

[26] For example, FINRA Rule 3110(e) requires as part of the background check on each new registered representative that a broker-dealer obtain and review a copy of the Form U5 filed by the last broker-dealer with which the individual was registered.

[27] Long investigative testimony, January 21, 2021, pages 92-93. It should be noted that the Form U5 from LPL reflected Hannan's termination from LPL as voluntary and not as "permitted to resign."

[28] *Id.*, page 102.

[29] Horter investigative testimony, March 4, 2021, page 51.

[30] *Id.*, pages 56 and 60.

[31] *Id.*, page 51.

As a result of the disclosures on Hannan's LPL Form U5 and FINRA's inquiry, Long recommended to Horter that Hannan's registration with HIM be terminated.[32] Horter rejected that recommendation and chose to allow Hannan to remain associated with HIM. Long testified, and Horter acknowledged, that Horter's rationale for that decision was that Hannan had been employed in the securities industry for some 40 years without any substantive compliance issues and that LPL had not determined to discharge Hannan as a result of the issues noted on Hannan's Form U5.[33]

Both Long and Horter stated that they did not believe they could obtain any information regarding Hannan's Form U5 disclosures from LPL. While that may well have been true, that did not preclude them from obtaining additional information that would help them better understand the issues disclosed by LPL. For example, Hannan could have been directed to provide more detailed information in writing and could have been asked to provide copies of any communications he had with LPL regarding the matters described on the Form U5. Similarly, they could have obtained copies of Hannan's communications with FINRA regarding its review of the Form U5 disclosures, which likely would have provided more information regarding those disclosures. Additionally, Horter and/or Long could have obtained more information from Hannan regarding the consulting he was doing, how he was compensated for that activity, the name of the entity through which he was engaged in that activity, and whether he intended to continue engaging in that activity while associated with HIM. None of this was done. Instead, Long and Horter simply accepted Hannan's explanation at face value.[34]

Allegations of prior misconduct by an adviser representative can inform supervisory principals concerning how they should supervise that adviser representative, including whether any kind of special supervision should be imposed. There does not appear to be any evidence that the disclosures on Hannan's LPL Form U5 had any effect on how he was supervised at HIM.

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[32] Long investigative testimony, January 21, 2021, pages 56-57.

[33] Long investigative testimony, January 21, 2021, pages 95-96. Horter investigative testimony, March 4, 2021, page 52.

[34] It does not appear that Hannan was asked about his alleged use of unapproved marketing materials at LPL.

In March 2015 an outside compliance consultant noted that HIM had no procedures governing the supervision of "higher risk" adviser representatives. The consultant's report stated, in relevant part:

> higher risk IAR's (those with previous disclosures and without IAR experience) require a program of closer supervision, particularly during the first years with Horter. Currently, no procedures call for such a review.[35]

In light of the fact that the majority of HIM's adviser representatives, like Hannan, were located away from HIM's home office, the compliance consultant also recommended that HIM create a risk-based branch office examination program. In its report, the consultant stated:

> The Firm should develop a more detailed procedure for supervising the activities of its remote IAR's. The procedure can be risk based, but the Firm must first do a risk assessment and build on its efforts to determine which individuals, branches, practices, and products require closer supervision.[36]

Despite identifying Hannan as a higher risk adviser representative,[37] no heightened supervision of any kind was imposed on him or his activities[38] and his office was never the subject of any kind of compliance review. Indeed, there is apparently no evidence that HIM or Horter supervised Hannan in any way.[39] HIM did ultimately draft written procedures for the review of higher risk

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[35] *Oyster Consulting, LLC RIA Compliance Program Review Report to Ice Miller LLP Counsel to Horter Investment Management, LLC*, March 26, 2015, page 4.

[36] *Id.*

[37] Long investigative testimony, January 22, 2021, pages 267-269.

[38] *Id.* When asked what additional requirements were imposed on Hannan as a result of designated him a "high risk advisor," Long responded: "We didn't do anything specific with Kimm Hannan as a result but now in hindsight, I wish we would have."

[39] See October 14, 2020 e-mail exchange between Horter's counsel, Matthew Fornshell, and Division of Enforcement attorney Jonathan Epstein. (SEC-SECCORR-E-0003254-0003255).

advisers, which included annual examinations of their offices, but those procedures were not adopted until after Hannan's misconduct came to light and only a few days before Hannan was terminated on March 24, 2017.[40]

Hannan's Outside Business Activities

When he initially joined HIM, Hannan disclosed on his Form U4 that he was involved in four business entities outside the scope of his association with HIM:

- Landowner Strategies, LLC, which Hannan described simply as an LLC;
- Hannan Town & Country, which Hannan identified as a dry cleaning business;
- Hannan Quality Cleaners, which Hannan also disclosed as a dry cleaning business; and
- Landowner Financial, LLC, which Hannan described as the "dba" entity through which he conducted his broker-dealer and investment advisory business.

Beyond the descriptions noted above and the number of hours each month he would be devoting to each business, it does not appear that Hannan provided any information regarding exactly what his associations with these entities would entail.[41] HIM's *Policies and Procedures Manual* in effect at the time Hannan joined HIM did not address the outside business activities of the firm's adviser representatives.

Hannan amended the disclosure of his outside business activities on his Form U4 in November 2016 to describe just two entities:

- Quality Cleaners, which Hannan described as a dry cleaning business; and

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[40] Exhibit 39 to Long's investigative testimony, *High Risk Advisors – Heightened Supervision Procedures*, March 20, 2017.

[41] Hannan's disclosure regarding Landowner Financial, LLC included the following statement: "No other advisers under Stratos use this name." It is unclear what that statement means or why it was included in the disclosure.

- Hannan and Associates, Inc., which Hannan described as a financial planning business.

As was the case with his initial disclosures, no other details were provided to HIM by Hannan regarding his activities with these entities.

The version of HIM's *Policies and Procedures Manual* in effect in April 2016 contained a section addressing outside business activities.[42] The *Manual* prohibited adviser representatives from engaging in outside business activities until they had received "prior approval from firm management and sign-off from the firm's Chief Compliance Officer." The *Manual* further noted that with respect to each outside business activity, firm management would:

> "consider, among other things, whether any proposed business activity may interfere with, or otherwise compromise, an IAR's responsibilities to Horter and its clients" and
>
> "consider whether any proposed outside business activity may be viewed by clients, customers, or the public as being part of Horter's investment advisory business."

The *Manual* also noted that the Chief Compliance Officer: "shall document the review and maintain it in the IAR's file." I have seen no evidence that this process was followed with respect to any of Hannan's outside business activities, including those he disclosed to HIM and that were reflected on his Form U4.

Prior to joining HIM, Hannan had apparently disclosed Hannan Properties to LPL as an outside business activity.[43] Horter testified that he believed he was aware of the existence of Hannan Properties but he was unsure

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[42] It does not appear that the *Policies and Procedures Manuals* in effect prior to April 2016 addressed outside business activities. Policies and procedures governing outside business activities should have been in place well before April 2016.

[43] See Exhibit 21 to Horter's investigative testimony, March 4, 2021, pages 71-72. It also appears that Hannan disclosed to LPL an entity called Stratos Wealth Partners, LLC, which was described as "DBA for LPL Business (Entity for LPL Business)." This is presumably the Stratos referred to on Hannan's Form U4 with HIM.

as to whether it had been disclosed in writing.[44] He testified that he assumed Hannan Properties was simply the name of an entity through which Hannan owned real estate.[45]

Long testified that he was unaware of Hannan's association with Hannan Properties.[46] He testified that he believed he had reviewed Hannan's registration records at the time Hannan joined HIM, which disclosed Hannan Properties as an outside business activity, but he had no recollection of seeing the reference to Hannan Properties.[47] Had the disclosure of Hannan Properties been noted, Hannan should have been questioned regarding what Hannan Properties was and whether he intended to continue engaging in activities through that entity. If Hannan did intend to continue engaging in business activities through Hannan Properties, that should have been disclosed as an outside business activity on Hannan's Form U4 with HIM.

In November 2016 Hannan sent a draft *Agreement* to Horter proposing a business relationship between HIM and a company Hannan had created, HR Resources. That document reflected that the owner of HR Resources was Hannan Properties.[48] It does not appear that any inquiry was made of Hannan at that time as to what Hannan Properties was or what activities it was engaged in.

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[44] Horter investigative testimony, March 4, 2021, page 107. There is no evidence that Hannan ever disclosed his association with Hannan Properties to HIM in writing. Nonetheless, in his May 25, 2022 deposition, Horter testified that Hannan Properties had been approved as an outside business activity by HIM (page 55).

[45] *Id.*, page 72. Hannan described Hannan Properties to LPL as: "Business Entity for Tax Purposes Only."

[46] Long investigative testimony, January 21, 2021, page 114 and January 22, 2021, page 225.

[47] A *Prospective New Advisor Scorecard* prepared when Hannan joined HIM reflected that Hannan's BrokerCheck report and his record in the IAPD system had been reviewed. Hannan's IAPD record identified Hannan Properties as an outside business activity in which Hannan was involved. Long signed the *Scorecard.*

[48] See Exhibit 47 to Long's investigative testimony, January 22, 2021, pages 252-253.

HR Resources

As noted above, in November 2016 Hannan approached Horter about having HIM invest in HR Resources. Hannan and Horter exchanged various e-mails regarding HR Resources and ultimately Horter refused to invest any money into that entity. On December 13, 2016, Hannan sent an e-mail to Horter in which he stated that he would no longer seek financing for HR Resources from HIM, stating: "I have taken it off the table and will find it elsewhere."

Horter testified that when he received this message he assumed Hannan's intention was to seek funding from one or more corporate entities Hannan had represented would be partnering with HR Resources. He stated that it did not occur to him that Hannan might seek those funds from HIM clients.[49] Horter testified that he did not ask Hannan where Hannan would seek the money for HR Resources and he was unaware of anyone else at HIM asking Hannan that question.[50]

HIM's compliance department notified Hannan via e-mail in January 2017 that he should amend his Form U4 to disclose HR Resources as an outside business activity.[51] Hannan apparently never responded to that notification and never amended his Form U4 to disclose HR Resources.

Delegation of Supervisory Responsibility

Horter acknowledged that he was the individual ultimately responsible for ensuring that HIM and its adviser representatives (including Hannan) conducted themselves in accordance with HIM's compliance policies and procedures.[52] He also acknowledged that he was the person within HIM who

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[49] Horter investigative testimony, March 5, 2021, pages 357-358 and 366 and Horter deposition, page 30.

[50] Horter investigative testimony, March 5, 2021, pages 357-359.

[51] Horter investigative testimony Exhibit 61, January 4, 2017 from Amy Baker to Hannan (HORTER-SEC062190).

[52] Horter investigative testimony, March 4, 2021, page 83. The 2015 and 2016 versions of HIM's *Policies and Procedures Manuals* each state: "The President, or a similarly designated officer, has overall supervisory responsibility for the firm."

was ultimately responsible for the supervision of Hannan.[53] Horter added that he was the sole person within HIM who had the authority to hire or fire adviser representatives.[54]

Horter stated that while he was ultimately responsible for the supervision of Hannan (and all of HIM's other adviser representatives), he delegated the responsibility for the direct supervision of Hannan to HIM's compliance department. He noted, however, that he was unaware of specifically what the compliance department did to supervise Hannan and he did nothing to confirm that compliance was carrying out that responsibility.[55] He stated:

> Well, Jason and I talk all the time. So, if there's issues with anything, Jason comes to see me, so. And again, we talk on a regular basis all day long.[56]

The SEC has noted that when a supervisory principal delegates supervisory responsibilities to another person, it is incumbent on the supervisory principal to take steps to ensure that the delegated functions are being performed. In that context, the SEC stated:

> It is not sufficient for the person with overarching supervisory responsibilities to delegate supervisory responsibility to a subordinate, even a capable one, and then simply wash his hands of the matter until a problem is brought to his attention...Implicit is the additional duty to follow-up and review that delegated authority to ensure that it is being properly exercised.[57]

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[53] *Id.*, page 34.

[54] *Id.*, pages 29-30, 38-39 and 75.

[55] Horter investigative testimony, March 4, 2021, pages 35-36 and 101-104. Horter similarly testified that he delegated to Long and the compliance department the responsibility to perform annual testing of HIM's compliance policies and procedures but that he did nothing to ensure that Long and the compliance department appropriately carried out that responsibility. Page 28.

[56] *Id.*, page 26.

[57] *In the Matter of Rita H. Malm*, SEC Administrative Proceeding File No. 3-7679, November 23, 1994.

Conclusions

Horter and HIM were obligated under the Advisers Act to create and implement policies and procedures reasonably designed to ensure that HIM and its adviser representatives conducted themselves in a manner that was compliant with the Advisors Act. While HIM maintained a *Policies and Procedures Manual,* prior to 2016 the *Manual* did not include any provisions for monitoring the disbursements of funds from client accounts to third parties. The absence of such policies and procedures was unreasonable. While policies and procedures were informally created in mid-2016 to provide for the monitoring of such disbursements, those policies and procedures were inadequate because (1) they did not clearly define how the monitoring of third-party disbursements would be conducted or supervised, (2) the appropriate staff was not provided with adequate training, and (3) there was no mechanism established to ensure that the policies and procedures were being complied with. As a result, Hannan was able to convert HIM client funds to his own use and benefit.

Beginning when Hannan first joined HIM, Horter and HIM were presented with several indications of the potential for misconduct by Hannan. Horter and HIM did not take reasonable steps to address any of those indications of potential misconduct:

- No substantive follow up was done regarding the disclosures on Hannan's Form U5 from LPL, which was the subject of a FINRA inquiry, other than obtaining a verbal explanation from Hannan. Indeed, it does not appear that any steps were taken to determine whether or not Hannan would continue through HIM the activities referenced on the LPL Form U5.

- Prior to April 2016, HIM's *Policies and Procedures Manual* did not address the outside business activities of its adviser representatives. Revisions to the *Manual* made in 2016 included procedures for the review and approval of outside business activities engaged in by HIM's adviser representatives. It does not appear, however, that those procedures were applied to any of the outside business activities Hannan disclosed to HIM and no substantive information appears to

have ever been obtained from Hannan regarding those activities. Additionally, no inquiry was made of Hannan regarding Hannan Properties, an outside business activity he had disclosed to LPL and which was reflected on his registration record that HIM apparently reviewed at the time he joined HIM.

- No action was taken by Horter or HIM to understand what steps Hannan planned to take to raise money for HR Resources, including whether he intended to solicit money from HIM clients, after Hannan informed HIM and Horter that he intended to seek funds from sources other than HIM.

Notwithstanding recommendations from an outside compliance consulting firm in March 2015, neither Horter nor HIM established policies or procedures for the supervision of higher risk adviser representatives such as Hannan, including the examinations of their offices, until days before Hannan was terminated. The procedures that were established were never applied to Hannan. The failure or Horter and HIM to establish such procedures was unreasonable. Additionally, I am aware of no records that Horter or HIM supervised Hannan in any manner.

While Horter testified that he delegated the day-to-day supervision of Hannan (and HIM's other adviser representatives) to others, there is no evidence that Horter ever took any steps to satisfy himself that that supervision was being conducted in an adequate and reasonable manner. This was unreasonable. As the SEC has noted, it is unreasonable for a supervisory principal to delegate supervisory responsibility to others without having a mechanism for verifying that those supervisory responsibilities were being carried out in a reasonable and adequate manner.

Based on the foregoing, I do not believe that Horter or HIM established reasonable compliance and supervisory systems or reasonably carried out the compliance and supervisory systems that they did have in supervising Hannan.

The opinions set forth in this report are based on information and documents I have received to date. I reserve the right to modify, supplement, or

otherwise amend this report and the opinions expressed herein if I am provided with any additional information or documentation regarding this matter.

Mainstay Capital Markets Consultants, Inc.

David E. Paulukaitis
Managing Director

6-17-22
Date

Exhibit 1

David E. Paulukaitis
Curriculum Vitae

Employment History:

2005 to Present Mainstay Capital Markets Consultants, Inc., Atlanta, GA

Managing Director

* Provide consulting services to broker-dealers and investment advisers with an emphasis on supervision and supervisory controls, regulatory examination planning and coordination, and regulatory risk management
* Provide assistance to state and federal securities regulatory organizations in sales practice investigations and enforcement proceedings, and conduct regulator-mandated undertakings
* Assist broker-dealers in sales practice investigations, registered representative continuing education and preventive compliance
* Review and analyze securities industry litigation/arbitrations

2009 to Present Advisory Services Network, LLC

Managing Member

* Conduct risk assessments and coordinate compliance activities for an SEC-registered investment adviser

1982 to 2005 NASD, District No. 7, Atlanta, GA

1994 to 2005 Associate District Director

* Responsible for overseeing the District's examination, surveillance, membership, and preventive compliance programs, including a staff of seven Supervisors, 40 examiners, and six support staff.
* Review and approve recommended dispositions of cycle and cause examinations and investigations.
* Responsible for planning and implementing annual member firm meetings, registered representative compliance workshops, the South Region Annual Compliance Seminar, and monthly staff meetings.
* Responsible for establishing and maintaining effective working relationships with SEC staff, various state securities regulators, banking regulators, and law enforcement authorities.

David E. Paulukaitis
Curriculum Vitae

1985 to 1994 **Supervisor of Examiners**

* Oversee an assigned portion of the District's cycle examination, surveillance, and membership programs, including supervising five to seven examiners.
* Directly supervise the District's Cause examination program.
* Recommend dispositions of cycle and cause examinations and investigations.
* Participate in District preventive compliance programs and initiatives.

1982 to 1985 **Examiner, Associate Examiner, and Senior Compliance Examiner**

* Conduct Cycle and Cause examinations.
* Perform financial surveillance analyses relating to assigned member firms.
* Evaluate membership applications and conduct Membership Interviews.
* Providing high quality support and assistance to member firms and investors.

Accomplishments:

* Two-time Winner of NASD Excellence in Service Award (1987 and 1999)
* Instructor for ten years in NASD's accredited examiner training program
* Member of several national NASD Steering Committees and Task Forces, including the RAP Small Cap Examination Program Steering Committee, the Cause Examination Task Force, the Steering Committee for the District Management Information System (NASD's first automated examination tracking system), and the Level 1 Committee (responsible for identifying NASD's highest risk broker-dealers)
* Frequent speaker at investor, broker-dealer, and securities industry conferences
* Frequent guest instructor at the annual NASAA examiner training program

Education:

University of Alabama in Huntsville
BSBA (Finance), with Honors, 1981

Exhibit 2

David E. Paulukaitis
NASD Employment Summary

I began my employment with NASD in January 1982 as an examiner, conducting routine examinations of broker-dealers, reviewing broker-dealer financial filings (such as FOCUS and annual audit reports), and processing the applications of entities seeking to register with NASD as broker-dealers. I additionally conducted investigations relating to investor complaints, the circumstances surrounding the termination of registration of registered representatives "for cause", and a variety of other matters involving alleged sales practice abuses.

In October 1985, I was promoted to Supervisor of Examiners and was assigned responsibility for overseeing the work of six examiners who conducted routine examinations and "cause" investigations, performed financial surveillance over NASD member firms, and processed new member applications. In June 1986, I was additionally assigned supervisory responsibility over the Atlanta District Office's "cause" investigation program.

In April 1994, I was promoted to Assistant District Director and became responsible for overseeing the routine examination, "cause" investigation, financial surveillance, and membership programs for the entire District Office (encompassing, at one point, a staff of 41 examiners and seven Supervisors of Examiners responsible for regulating more than 600 member firm broker-dealers). In April 1996, I was promoted to Associate District Director, retaining the same job responsibilities.

As an examiner and Supervisor with NASD, I personally participated in approximately 100 broker-dealer examinations involving the review of financial/operational and sales practice activities. I also personally conducted several thousand "for cause" investigations involving specific allegations of misconduct by broker-dealers and their registered representatives. As a Supervisor and Assistant/Associate Director, I reviewed several thousand more examinations and investigations and was responsible for recommending or approving/rejecting the disposition of those matters recommended by the senior

examiners and Supervisors who reported to me. These matters involved virtually every aspect of broker-dealer compliance, operations and supervision.

While serving as Assistant and Associate Director, I was also responsible for the District Office's member outreach program, which included planning and conducting annual compliance seminars, member firm meetings, and registered representative compliance training workshops.

While employed with NASD, I participated in a variety of national initiatives. Among other things, I served as an instructor in NASD's accredited examiner training program for ten years and participated in an assortment of national projects and committees, including serving as a member of the steering committee for NASD's Small Cap Examination Program, which oversaw a number of high profile examinations of broker-dealers engaged in abusive sales practices in the small cap securities market. I also participated as a member of the steering committees that created NASD's Cause Examination Procedures Manual and NASD's first automated examination tracking system.

In addition to the foregoing, I am one of a handful of two-time recipients of NASD's highest employee recognition award, the Excellence in Service Award.

David E. Paulukaitis
Post-NASD Testimony and Expert Experience

Arbitrations:

In the past four years, I testified as an expert witness for the Respondents in the following matters:

FINRA Case No. 13-01876, Jessica Parker and Bryan Valentine v. Interactive Brokers, LLC

FINRA Case No. 16-00658, Richard Levine v. UBS Financial Services, Inc.

FINRA Case No. 16-01223, Ivan Gefen v. Morgan Stanley Smith Barney, Inc.

FINRA Case No. 16-02506, Sheldon and Judith Ferkey v. TD Ameritrade, Inc.

FINRA Case No. 16-02594, Carol Rizzo v. International Assets Advisory, LLC

FINRA Case No. 16-02863, Mark E. Viator v. National Securities Corporation

FINRA Case No. 16-03390, Nola Lanelle Jenkins v. Scottrade, Inc.

FINRA Case No. 17-00078, Sam Freeland v. TD Ameritrade, Inc.

FINRA Case No. 17-01547, Peter Lawrence, et al. v. TD Ameritrade, Inc.

FINRA Case No. 17-01642, Congregation Machzikei Hadas v. TD Ameritrade, Inc.

FINRA Case No. 17-02152, Antonia Barone v. Commonwealth Financial Network

FINRA Case No. 17-02561, Kevin Barley v. Morgan Stanley Smith Barney, Inc.

FINRA Case No. 17-02703, Richard Zane v. Investment Architects, Inc.

FINRA Case No. 17-03513, David and Sally Ball, et al. v. Sunset Financial Services, Inc.

FINRA Case No. 18-00543, Paula Adams v. UBS Financial Services, Inc.

FINRA Case No. 18-00853, Robert Meyer, et al. v. Ameriprise Financial Services, Inc.

FINRA Case No. 18-01140, Scott J. Tepper v. Vanguard Marketing Group

FINRA Case No. 18-01404, Min Zhao v. TD Ameritrade, Inc.

FINRA Case No. 18-01489, Harry Paez v. Securities America, Inc.

FINRA Case No. 18-02760, Rodney M. Dabbondanza v. H. Beck, Inc.

FINRA Case No. 18-03287, Annabelle Datzker Trust v. UBS Financial Services, Inc.

FINRA Case No. 18-03572, Stine Seed Farm, Inc. v. D.A. Davidson & Co.

FINRA Case No. 18-03652, Ivanna Jazmin Freddi, et al., UBS Financial Services, Inc.

FINRA Case No. 18-03754, David and Linda Watts v. UBS Financial Services, Inc.

FINRA Case No. 18-03815, Robert McCabe v. Morgan Stanley

FINRA Case No. 19-00085, Palm Beach Equity Financing Fund v. TD Ameritrade, Inc.

FINRA Case No. 19-00132, Salvatore and Christine Abbate v. Calton & Associates, Inc.

FINRA Case No. 19-00519, PKS Investments v. TD Ameritrade, Inc.

FINRA Case No. 19-00522, Gerald S. Backman v. UBS Financial Services, Inc.

FINRA Case No. 19-00636, Richard and Barbara Brody v. UBS Financial Services, Inc.

FINRA Case No. 19-01410, Sherrie Pellini v. UBS Financial Services, Inc.

FINRA Case No. 19-01538, Marie Mesmer v. Raymond James Financial Services

FINRA Case No. 19-01813, Dale Hadel, et al. v. Ameriprise Finanical Services, Inc.

FINRA Case No. 19-02180, Amanda B. Straight Revivable Trust v. UBS Financial Services, Inc.

FINRA Case No. 19-02276, Shuichi Iizumi v. Interactive Brokers, LLC

FINRA Case No. 19-02750, GMS Mine Repaid and Maintenance, Inc. v. NEXT Financial Group, Inc.

FINRA Case No. 19-03212, Austin W. Morton v. Edward Jones

FINRA Case No. 19-03519, Bradford Kittle v. National Securities Corporation

FINRA Case No. 20-00111, Zbigniew Bart Wojewnik v. Allstate Financial Services, LLC

FINRA Case No. 20-00161, Carol and Robert Avery v. Ameriprise Financial Services, Inc.

FINRA Case No. 20-00870, Timothy Hourihan v. Voya Financial Partners, LLC

FINRA Case No. 20-00944, Julian Skalski v. TD Ameritrade, Inc.

FINRA Case No. 20-01070, Jess DiPasquale v. UBS Financial Services, Inc.

FINRA Case No. 20-01899, Stephen and Kristi Trowbridge v. Kestra Financial Services, LLC

FINRA Case No. 20-01987, Karen Von Burg v. Calton & Associates, Inc.

FINRA Case No. 20-02764, Richard Kincheloe, V. v. UBS Financial Services, Inc.

FINRA Case No. 20-03126, James Freund v. Ameriprise Financial Services, Inc.

FINRA Case No. 20-03293, Jeff and Susan Trosen v. Ameriprise Financial Services, Inc.

FINRA Case No. 20-03296, Andrew Chisholm v. Ameriprise Financial Services, Inc.

FINRA Case No. 20-03742, Melanie Meadows v. Ameriprise Financial Services, Inc.

In the past four years, I testified as an expert witness for the Claimants in the following matters:

FINRA Case No. 16-00910, VALIC Financial Advisors, LLC v. Brett and Jessica LaFerrera

FINRA Case No. 17-03439, Mike and Nita Snow v. First Allied Securities, Inc.

FINRA Case No. 18-04045, Raymond James & Associates, Inc. v. Stephen J. Florio

FINRA Case No. 19-01560, Wells Fargo Advisers, Inc. v. James C. Shelburne

Litigation:

During the last four years I have testified as an expert on behalf of the defendant in the matter of *John and Bonnie Bernadowski v. Ameriprise Financial Services, Inc.* (Court of Common Pleas, Allegheny County Pennsylvania, G.D. 01-008101).

During that same time period I testified as an expert on behalf of the plaintiff in the matter of *Sandra Althaus v. Carrie McAninch* (U.S. Bankruptcy Court, District of Nevada, Adversary Case No. 16-05031-gwz). I also testified as an expert on behalf of the Department of Enforcement of the SEC in the matter *U.S. Securities and Exchange Commission v. Adam Mattessich* (U.S. District Court, Southern District of New York, Civil Action No. 18-cv-05884).

Depositions:

During the last four years, I have given deposition testimony in the following matters:

U.S. Securities and Exchange Commission v. Stifel, Nicolaus & Co., Inc., U.S. District Court, Eastern District of Wisconsin, Case No. 2.11-vd-755

Laura Coffey v. David L. Coffey, et al., Chancery Court for Knox County, Tennessee, No. 189999-2

UBS Financial Services, Inc. v. Bounty Gain Enterprises, Inc., U.S. District Court, Southern District of Florida; Case No. 9:14-cv-81603.

Sandra Althaus v. Carrie McAninch, U.S. Bankruptcy Court, District of Nevada, Adversary Case No. 16-05031-gwz.

Nora Fernandez, et al. v. UBS Financial Services, Inc., U.S. District Court, Southern District of New York, No. 15-cv-02859-SHS

U.S. Securities and Exchange Commission v. Adam Mattessich; U.S. District Court, Southern District of New York, Civil Action No. 18-cv-05884

U.S. Securities and Exchange Commission v. Kerry L. Hoffman; U.S. District Court, Northern District of Illinois, Civil Action No. 19-cv-4409

H. Beck, Inc. v. Health & Wellness Lifestyle Club, LLC; U.S. District Court, Northern District of Ohio, Case No. 5:20-CV-01413

New Hampshire Bureau of Securities v. AOS, Inc., COM.2018-0002

Publications

I have not independently authored any professional publications in the last ten years.

EXHIBIT B

Expert Rebuttal Report

David E. Paulukaitis, Managing Director
Mainstay Capital Markets Consultants, Inc.

In the Matter of Horter Investment Management, LLC
and
Drew K. Horter

United States Securities and Exchange Commission
Administrative Proceeding
File No. 3-20531

July 15, 2022

This report has been prepared to respond to opinions set forth in the May 11, 2022 Expert Report of Lisa Roth, who has been designated as an expert witness for Horter Investment Management, LLC ("HIM") and Drew K. Horter ("Horter") in conjunction with the administrative proceeding initiated against them by the Division of Enforcement of the U.S. Securities and Exchange Commission (the "Division"). This supplements my June 17, 2022 Expert Report.

Summary

The Division's allegations primarily pertain to the alleged failure of HIM and Horter reasonably to supervise Kimm Hannan ("Hannan") resulting in their failure to detect and prevent Hannan from converting to his own use and benefit more than $700,000 from the accounts of HIM clients. As explained in the *Order Instituting Administrative and Cease and Desist Proceedings* (the "*Order*"), Hannan converted client monies to his own use and benefit through the use of more than a dozen third-party disbursement requests which directed that funds be sent to the bank account of an entity called Hannan Properties, which Hannan controlled. HIM processed each of those disbursement requests even though each request clearly reflected that it was made payable to a Hannan-controlled entity that shared his name.

While the bulk of Ms. Roth's 44-page report addresses her opinion that the overall supervisory systems and procedures within HIM were reasonable and that Horter's role in implementing those systems and procedures was reasonable (an opinion with which I disagree), the report says nothing about Hannan's conversion of client funds until page 41. Ms. Roth ultimately concludes that HIM supervisory systems and procedures for supervising the disbursement of funds from client accounts were reasonable because:

> The policy was not designed to root out what Hannan did. The purpose behind HIM's procedure of collecting and validating information about the transfers was to confirm the client's instructions and prevent a phishing incident.[1]

[1] Roth Expert Report, page 44.

I agree with Ms. Roth's assessment of the procedure HIM established for the review of disbursements from client accounts—it was not designed to detect the conduct in which Hannan engaged. This is exactly why, in my opinion, HIM's systems and procedures were deficient. HIM's procedures with respect to the disbursement of funds from client accounts failed for two primary reasons. First, in creating the procedures HIM failed to address the fundamental risk that one of its adviser representatives might attempt to convert client funds to his/her own use and benefit. Second, HIM did not provide for a supervisory review of disbursements from client accounts that focused on potential misconduct, either by the client's adviser representative, an employee of the firm, or the client himself/herself.[2] Had these factors been considered in structuring HIM's procedures for processing disbursements from client accounts, it is highly likely that Hannan's misconduct would have been detected and prevented.[3]

Ms. Roth opines in her Expert Report that the additional supervisory deficiencies cited in the *Order* are misplaced. She opines that the procedures contained in HIM's *Policies and Procedures Manual* "provided a solid framework for a successful compliance program"[4] and that "[t]he design, organization and administration of HIM's supervisory model was well-tailored to the firm's business model and complied with relevant SEC guidance."[5] She adds: "HIM developed a compliance and supervisory program with structure and depth that

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[2] Misconduct by a client could include, for example, money laundering.

[3] HIM's *Policies and Procedures Manuals* in place during the time Hannan was associated with the firm each included a section on anti-money laundering. While these sections of the *Manuals* did not specifically address the review of disbursements from client accounts (which is an integral part of anti-money laundering compliance), they did include the following statements:

> Anti-money laundering ("AML") compliance is the responsibility of every employee. Therefore, any employee detecting any suspicious activity is required to immediately report such activity to the AML Compliance Officer.

The *Manuals* do not describe the types of suspicious activity that employees of HIM should be alert to and should report. (HORTER-SEC044968-045035, HORTER-SEC045074-045139, and HORTER-SEC045217-045282).

[4] Roth Expert Report, page 11.

[5] *Id.*, page 27.

could reasonably be expected to detect and prevent wrongdoing."[6] I disagree. I believe the evidence reflects fundamental failures by both HIM and Horter to establish reasonable supervisory procedures and also to actually supervise in a reasonable manner. The litany of supervisory failings identified in the *Order* and described in my June 17, 2022 Expert Report, I believe, support that conclusion.

Compliance Policies and Procedures for Third-Party Distributions

Ms. Roth's Expert Report notes in several places that Rule 206(4)-7 of the Investment Advisers Act of 1940 (the "Advisers Act") does not dictate the structure or content of the supervisory systems and procedures investment advisory firms are required to establish.[7] I agree and I acknowledged that in my Expert Report.[8] However, as I pointed out in my Expert Report, the SEC's expectation for compliance with Rule 206(4)-7 is that:

> Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks.[9]

One of the risk areas specifically identified by the SEC was: "Safeguarding of client assets from conversion or inappropriate use by advisory personnel."[10] There is no evidence that HIM or Horter ever did anything to address this risk

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[6] *Id.*, page 16.

[7] For example, on page 7 of Ms. Roth's Expert Report she states: "the SEC does not prescribe a set of specific elements required in an adviser's policies and procedures". On page 8 she states: "The rule does not require the CCO of an adviser to prepare a report that summarizes the results of the annual review." And on page 15 she states: "There are no SEC rules for investment advisers that require cyclical examinations of the branches, oversight of associated persons' outside activities, or mandatory methods for supervision including heightened supervision or other such requirements."

[8] See my Expert Report, pages 10-11.

[9] *Final Rule: Compliance Programs of Investment Companies and Investment Advisers*, SEC Release No. IA-2204, February 5, 2004.

[10] *Id.*

and there is nothing in Ms. Roth's report that explains why the failure of HIM and Horter to address this risk was reasonable.

I believe HIM failed to establish a reasonable supervisory process for the review of disbursements from client accounts and failed reasonably to supervise.

Jason Long ("Long"), who was HIM's Chief Compliance Officer, testified that when he was first designated as HIM's Chief Compliance Officer "third-party distributions was one of the items on my radar."[11] In a subsequent e-mail drafted in June 2016 for distribution to HIM's adviser representatives, he stated: "Distributions to third parties are the highest risk transaction that our organization faces."[12] Despite this, HIM adopted no written procedures governing the processing and supervisory review of third-party disbursements from client accounts until October 2017, a year and a half after Long was designated as HIM's CCO, more than a year after Long's draft e-mail to HIM's adviser representatives, and six months after Hannan was terminated for converting client funds through the use of third-party disbursement requests.[13]

Because no written procedures had been drafted, when HIM initiated the use of a *Client Distribution Request Log* in mid-2016 to record third-party disbursements, training regarding the use of the *Log* was conveyed verbally. This resulted in apparent confusion between Jessica Vierling ("Vierling"), the Trading Department employee responsible for processing disbursement requests, Kevin Hetzer ("Hetzer"), the person primarily responsible for approving each disbursement, and Long regarding which transactions were required to be recorded on a *Log* and subsequently reviewed.[14] Vierling received no training to help her understand how to identify questionable or problematic disbursement requests[15] and Hetzer testified that the only substantive action he

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[11] Long investigative testimony, January 22, 2021, page 190.

[12] See Exhibit 3 to the deposition of Kevin Hetzer, February 9, 2022 (HIM_SEC062638.002).

[13] Third-Party Distribution Procedures, October 17, 2017, Exhibit 26 to the investigative testimony of Long, January 22, 2021 (SEC-InvTestimony-000212-Long).

[14] See my Expert Report, pages 11-12.

[15] Vierling investigative testimony, March 18, 2021, page 54.

took in reviewing transactions was to confirm with Vierling that she had spoken to the client.[16]

Notwithstanding Long's view that third-party disbursements were "the highest risk transaction that our organization faces," there is no evidence that Hetzer or anyone else viewed any disbursements from client accounts with a critical eye in order to identify any questionable disbursements (particularly instances in which the payee shared the same name as the adviser representative who submitted the request). This occurred, in part, because HIM had no procedures, written or otherwise, addressing even generally what the supervision should seek to accomplish. I believe it is clear that HIM's procedures governing the processing and review of third-party disbursements from client accounts did not reflect the "structure and depth that could reasonably be expected to detect and prevent wrongdoing" described by Ms. Roth.

Long advised HIM staff that one of the benefits of the *Log* was that it provided HIM's Compliance Department with a mechanism by which disbursements from client accounts could be reviewed.[17] However, there were no procedures addressing the review of the *Log* by the Compliance Department and Long and Vierling each acknowledged that the Compliance Department never actually reviewed the *Log* at any time.[18]

Complying With Client Instructions

In her Expert Report, Ms. Roth suggests that HIM's sole responsibility when receiving disbursement instructions from a client was to it process that disbursement as directed and that it would be improper "to pry about the client's rationale in requesting the distribution, whether there were promises made in connection with the transfer or what the transferee offered them in return." She additionally states: "Interfering with a client's instruction to distribute monies

[16] Hetzer deposition, pages 43-44.

[17] Exhibit 8 to Vierling investigative testimony (SEC-InvTestimony-000783).

[18] Long investigative testimony, January 22, 2021, page 223, and Vierling deposition, page 65.

from their account is a conflict of interest because an investment adviser is compensated by AUM retained at the firm."[19]

Certainly, a client controls his/her funds and an investment adviser is obligated to follow legitimate disbursement instructions submitted by that client. That does not mean, however, that an investment adviser must blindly process a disbursement request and take no steps to satisfy itself that there is nothing improper associated with that disbursement. If, as Ms. Roth suggests, an investment advisory firm's primary duty is to process disbursement requests without question, no firm would ever be able to prevent its adviser representatives from stealing client funds. Similarly, no firm would ever be able to detect or prevent money laundering or any other illegal activities in which a client might be involved. As I opined in my Expert Report, if HIM had established third-party distribution procedures to identify suspicious or questionable disbursements, and if employees had been properly trained on how to review those disbursements, it is likely that Hannan's misconduct would have been detected.[20]

Outside Business Activities

As noted above, Ms. Roth's Expert Report states there are no SEC rules that require "oversight" of the outside business activities of advisory representatives. If by use of the word "oversight" Ms. Roth meant to suggest that HIM had no duty to supervise Hannan's outside business activities, then I agree with her. If, however, her use of that word was intended to suggest that HIM had no duty to understand the nature of Hannan's outside business activities and how they might conflict with his activities on behalf of HIM, then I disagree with her, as do HIM's own policies and procedures.

Advisory firms like HIM are required to have each adviser representative disclose his/her outside business activities on his/her *Uniform Application for Securities Industry Registration* ("Form U4") so the firm can evaluate whether those activities conflict in any way with the activities of the firm or the interests of clients. Advisory firms are then required to disclose outside business activities on each representative's Form ADV Part 2B Brochure Supplement, which is

[19] Roth Expert Report, page 43.

[20] See my Expert Report, page 15.

provided to clients. As the SEC has explained, "The brochure supplement must describe the supervised individual's other business activities and any material conflicts of interest that such participation may create."[21] The purpose of providing this information to clients is to allow them to be aware of any activities that could have an effect on the advisory services provided to them by their adviser representative.

Hannan disclosed to HIM on his Form U4 that he was engaged in outside business activities.[22] As I noted in my Expert Report, there is no evidence HIM took any steps to understand the nature of those activities.[23] Additionally, there is no evidence HIM took any steps to reconcile the outside business activities disclosed on Hannan's Form U4 with those he had disclosed to his prior firm, LPL Financial, LLC ("LPL").[24]

HIM disclosed on Hannan's Form ADV Part 2B Brochure Supplement that Hannan engaged in outside business activities, but that disclosure only addressed Hannan's purported activities as an independent insurance agent.[25] None of the outside business activities Hannan disclosed to HIM were reflected on his Brochure Supplement. Further, none of the activities Hannan disclosed to HIM suggested he was engaged in the sale of insurance products.

As I noted in my Expert Report, Horter testified he was aware of Hannan Properties and he believed HIM had approved it as an outside business activity.[26] Hannan Properties never appeared as an outside business activity for Hannan on any HIM record.

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[21] *Investor Bulletin: Form ADV – Investment Adviser Brochure and Brochure Supplement*, SEC, June 24, 2016.

[22] Exhibit 15 to Long's investigative testimony, January 21, 2021 (HORTER-SEC000733-000752).

[23] See my Expert Report, pages 19-21.

[24] Those outside business activities were disclosed on Hannan's Investment Adviser Public Disclosure ("IAPD") system report (HORTER-SEC000588-000566), which was one of the records apparently reviewed by HIM as part of the on-boarding process leading up to Hannan joining HIM. See *Prospective New Advisor Scorecard* (HORTER-SEC000522).

[25] Hannan's Brochure Supplement (Horter-SEC114061-114065).

[26] See my Expert Report, pages 20-21.

When Hannan joined HIM in late 2014, HIM's *Policies and Procedures Manual* did not address the outside business activities of the Firm's adviser representatives. Procedures were added to the April 2016 version of the *Manual* addressing outside business activities and they called for the following:

- the Chief Compliance Officer was required to "sign-off" on all outside business activities;
- a determination was to be made whether an outside business activity presented a conflict to HIM or its clients or would be viewed by clients or members of the public as being part of HIM's investment advisory business; and
- records evidencing the review of each outside business activity were to be maintained.[27]

None of this was done with respect to Hannan's disclosed outside business activities, including when he amended his outside business activities disclosures in November 2016.

While HIM had procedures in April 2016 relating to outside business activities that appeared, on their face, to be reasonable, the firm failed reasonably to carry out those procedures.

Hannan's Duty to Comply

Ms. Roth notes in her Expert Report that Hannan had a duty to comply with applicable securities industry rules and HIM's compliance program. She adds that in November 2014 HIM conveyed the firm's requirements to Hannan in his "Welcome Packet" and required Hannan to sign a variety of documents wherein he represented that he understood his compliance obligations. Ms. Roth concludes that these documents "demonstrate HIM's efforts to communicate the importance of compliance and supervision to Mr. Hannan." Ms. Roth further states "it was reasonable for HIM to rely on Hannan to provide truthful and honest information and to comply with the firm's compliance program."[28]

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[27] *Id.*, page 20.

[28] Roth Expert Report, pages 36-37.

I agree with Ms. Roth that Hannan was obligated to comply with securities industry rules and HIM policies and that it was reasonable for HIM to remind Hannan of that obligation. That does not, however, obviate the duty of HIM and Horter to reasonably supervise Hannan's activities.

The purpose of establishing a supervisory and compliance system is to allow a firm to independently confirm that adviser representatives are acting in a manner consistent with securities industry rules and regulations, as well as the firm's own policies and procedures. As such, while it was appropriate for HIM to take steps intended to remind Hannan of his personal compliance obligations, doing so did not in any way discharge the supervisory obligations imposed on HIM and Horter under the Advisers Act to detect and prevent misconduct by Hannan. Simply reminding an adviser representative of his/her compliance obligations does not constitute reasonable supervision.

Implementation of Supervisory and Compliance Enhancements

In early 2015, Horter and HIM retained Oyster Consulting, LLC ("Oyster") to assist HIM in reviewing and enhancing its compliance and supervisory systems and procedures. In March 2015, Oyster prepared a report summarizing its findings and recommendations.[29] Ms. Roth stated in her Expert Report that HIM's response to the Oyster report was "methodical and on-going."[30] In reality, HIM appears to have been slow to act or did not act at all on many of the recommendations in the Oyster report. For example:

- The Oyster report stated that HIM's "growing, nationwide [adviser representative] force is the greatest supervision and compliance risk the Firm faces." The report further stated that in October 2014 HIM had "recently taken steps to identify branches that may require enhanced supervision." In that regard, the Oyster report noted that a risk assessment would help HIM identify "certain offices or [adviser representatives] that require regular or ad hoc on-site examinations.[31]

[29] HORTER-SEC091166-091176.

[30] *Id.*, page 19.

[31] Oyster report, page 4.

HIM did not begin examining branch offices until 2017 (two years later).[32]

- The Oyster report recommended that HIM "should develop a more detailed procedure for supervising the activities of its remote [adviser representatives]."[33] I have seen no evidence HIM took any specific steps to more closely supervise the activities of any adviser representatives in the years following the Oyster report. HIM only adopted policies and procedures setting forth the steps that would be taken to supervise the activities of adviser representatives deemed by HIM to be "high risk" after Hannan's misconduct came to light and only a few days before Hannan was terminated on March 24, 2017.

- The Oyster report recommended that HIM establish "procedures for the annual testing and review of the firm's [compliance] program...for identifying deficiencies in both practice and in procedure."[34] Ms. Roth stated in her Expert Report that the Oyster report satisfied HIM's annual review requirement for 2015. I agree that the review conducted by Oyster could reasonably be deemed the annual testing for 2015. I disagree with Ms. Roth, however, regarding the testing done before and after 2015.

    - Ms. Roth states in her Expert Report that the establishment of a Risk Committee in 2014 and the undertaking of a Risk Assessment satisfied the testing requirements for 2014. It appears that Oyster disagreed, noting in its report that HIM "has not had a thorough annual compliance review in several years."[35] I concur with Oyster. I have seen nothing to suggest that the Risk Committee did any work of substance that

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[32] Long investigative testimony, January 21, 2021, page 42-43.

[33] Oyster report, pages 3 and 4.

[34] *Id.*, page 4.

[35] *Id.*, page 5.

contributed to the testing of HIM's supervisory and compliance system in 2014 or thereafter.[36]

- Ms. Roth states in her Expert Report that the fact that a variety of additional policies and procedures were implemented in 2016 and 2017 was evidence that testing was done in each of those years. I disagree. The fact that a firm adds new policies or procedures does not in and of itself evidence that an overall review of the firm's supervisory and compliance systems was performed. There is no evidence that any substantive review was conducted.[37]

- The Oyster report also noted that HIM was exploring the use of an e-mail service provider that would retain and facilitate the review of e-mail.[38] HIM did not actually engage a service provider for this purpose until late 2017 (almost three years later).[39]

Supervision of "High Risk" Adviser Representatives

Ms. Roth opines in her Expert Report that Hannan was not a "high risk" adviser representative. She notes that in 2016, two years after Hannan joined HIM, the SEC initiated a review of adviser representatives it deemed to be "high risk," based on a set of criteria selected by the SEC. In 2019 the SEC published the criteria it used. Ms. Roth notes that Hannan did not meet those criteria.[40]

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[36] I have seen nothing evidencing that the Risk Committee ever met after the date of the Oyster report or that it ever took any actions. A November 30, 2018 document entitled "Annual Review of Compliance Program," which apparently evidenced the annual review of HIM's compliance program for 2018, noted: "The Risk Committee was reformed in 2018," suggesting that the Committee had been disbanded at some point after it was established.

[37] Unlike prior years, HIM prepared documents evidencing that it had actually conducted annual reviews for the years 2018 and 2019. (HORTER-SEC091177-091180 and HORTER-SEC091615-091664).

[38] Oyster report, page 8.

[39] Long investigative testimony, January 21, 2021, page 44 and the 2018 *Annual Review of Compliance Program* (HORTER-SEC091177).

[40] Roth Expert Report, page 29.

She adds that the Oyster report also identified criteria for "high risk" adviser representatives and Hannan similarly did not meet those criteria.[41] It is important to note, however, that Hannan was not identified as a high risk adviser by the SEC, the Division, or Oyster, but rather by HIM itself.[42] Long testified he determined Hannan should be designated as "high risk" because of the disclosure on the *Uniform Termination Notice for Securities Industry Registration* ("Form U5") filed by LPL on behalf of Hannan.[43] In April 2016, Hannan was again identified as "high risk" in a *Compliance Monthly Report Package* prepared by Long.[44]

When asked what restrictions or other requirements were imposed on Hannan as a result of the "high risk" designation, Long responded: "We didn't do anything specific with Kimm Hannan as a result but now in hindsight, I wish we would have."[45] Long added that while the LPL Form U5 disclosure warranted Hannan being designated as "high risk," he ultimately concluded that it did not rise to a level that warranted closer supervision.[46] Nonetheless, HIM again identified Hannan as "high risk" a year and a half after he joined HIM and still imposed no restrictions or other requirements on him.

The Oyster report noted that while HIM was taking steps to identify potential high risk adviser representatives, it had not initiated any processes for more closely supervising those representatives. Despite Oyster's recommendation that a process be created for supervising those representatives, there is no evidence that HIM established such procedures until March 20, 2017, after Hannan's misconduct was discovered and days before his termination.[47]

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[41] *Id.*, page 35.

[42] Long investigative testimony, January 22, 2021, page 267.

[43] Prior disclosures such as the LPL Form U5 were one of the criteria identified by Oyster for designating a representative as "high risk."

[44] Exhibit 40 to Horter's investigative testimony (SEC-InvTestimony-000656-000670).

[45] Long investigative testimony, January 22, 2021, pages 267-268.

[46] *Id.*, page 269.

[47] Exhibit 39 to Long's investigative testimony, *High Risk Advisors – Heightened Supervision Procedures*, March 20, 2017. HIM's *Prospective Advisor Due Diligence Procedures* dated September 20, 2014 included a process for categorizing prospective new recruits as "green," "yellow," or "red" based upon, among other things, the number of

Ms. Roth states in her Expert Report that Hannan's on-boarding at HIM was "complete and robust," notwithstanding the fact that the on-boarding process did not include a review of the Form U5 filed by LPL on behalf of Hannan or a review of Hannan's previously disclosed outside business activities. While Ms. Roth's Expert Report notes that Hannan's reporting of an inquiry by FINRA regarding the disclosures on his LPL Form U5 was "the first notice that HIM had that there were issues that had arisen at the prior employer,"[48] HIM would have been aware of it had they simply reviewed Hannan's registration records, as should be done in any reasonable on-boarding process.[49]

In her Expert Report, Ms. Roth acknowledges that upon receipt of notice regarding the FINRA inquiry, Long recommended that Hannan's registration be terminated. She then identifies three possible courses of action that HIM and Horter could take:

> Mr. Horter's available courses of action included immediate termination (Mr. Long's recommendation), contacting the prior brokerdealer (unlikely to yield a substantive response), or wait for the outcome of the FINRA investigation.

Ms. Roth concludes that waiting for the conclusion of the FINRA inquiry was a "reasonable response" for Horter to take.[50] I disagree.

Horter and HIM had a duty to supervise Hannan. They could not and should not have relied on FINRA to fulfill what was ultimately their duty to

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disclosures the prospective new recruit had. While the 2014 *Procedures* noted that a prospect categorized as "red" should be rejected (which rejection could be overridden by "Executive Management"), they did not address steps that would be taken if a prospective new recruit categorized as "high risk" was hired.

[48] Roth Expert Report, page 32.

[49] In addition to Hannan's IAPD report, HIM had access to the Central Registration Depository ("CRD"), which contains all records regarding Hannan over his entire career in the securities industry, including the LPL U5. HIM used CRD to electronically register Hannan and to subsequently electronically terminate that registration, but HIM apparently never reviewed that system in conjunction with the on-boarding process.

[50] Roth Expert Report, page 33.

evaluate whether Hannan should be hired (or continue to be employed) and, if so, whether he should be subject to some sort of heightened supervision.[51] As I noted in my Expert Report, Horter and HIM were not limited to the three options cited by Ms. Roth.[52] At the very least, it would have been reasonable for Horter and HIM to require Hannan to provide them with copies of his communications with, and any documents provided to, FINRA. Doing so would not only help Horter and HIM better understand the conduct that raised concerns to LPL but it would also help them understand how that conduct might affect how they should supervise Hannan.[53] Instead, Horter and HIM did nothing.

HR Resources

Ms. Roth's Expert Report touches briefly on HR Resources, primarily to address whether that entity should have been treated (and disclosed by Hannan) as an outside business activity. Inasmuch as HIM's compliance department directed Hannan to disclose HR Resources as an outside business activity in January 2017,[54] it appears that HIM concluded it did constitute an outside

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[51] NASD, the predecessor of FINRA, noted with respect to its investigation of customer complaints:

> NASD's decision to close an investigation without further action can result from many factors unrelated to the merits of a complaint, such as jurisdictional limitations or the existence of an ongoing or completed enforcement action by another law enforcement or regulatory agency. (Notice to Members 02-53, *NASD Rule 3070*, August 2002)

The same principle is true of other types of investigations, including investigations of Form U5 disclosures. The determination by FINRA (and NASD before it) to close an investigation without action does not mean FINRA has affirmatively determined that a registered person did not engage in misconduct.

[52] See my Expert Report, page 17.

[53] The disclosure by LPL on Hannan's U5 stated, in part, that questions were raised about Hannan depositing money into his "DBA." See Exhibit 32 to Horter deposition, Mat 25 2022, pages 6-7). Hannan apparently told Long that the funds in question represented compensation to him for consulting with clients about the best legal structure to use for holding oil and gas investments. There is no evidence that Horter or anyone else at HIM made any effort to determine what entity the funds were deposited to or if Hannan planned to continue that activity while associated with HIM.

[54] HORTER-SEC062190.

business activity. However, Hannan apparently ignored the request and HIM did not follow up.

Notably, Ms. Roth's Expert Report does not address the failure of HIM and Horter to follow up on Hannan's December 2016 representation that since Horter and HIM would not provide funding to HR Resources, Hannan would "find [funding] elsewhere."[55] It was not reasonable for Horter to simply accept a representation like that from Hannan and not clarify specifically where Hannan intended to seek that financing, including the possibility he intended to solicit it from HIM clients.

Delegation of Supervisory Authority

Ms. Roth's concludes in her Expert Report that Horter delegated supervisory authority to others "reasonably and effectively."[56] She states the delegation was reasonable because it was given to individuals who were qualified to take on the supervisory responsibilities delegated to them. She also points out that the delegees had the opportunity to discuss with Horter in weekly meetings any concerns they had and that otherwise Horter's "door was open" to address any ad hoc concerns they might have.[57]

As I noted in my Expert Report, the SEC has stated:

> It is not sufficient for the person with overarching supervisory responsibilities to delegate supervisory responsibility to a subordinate, even a capable one, and then simply wash his hands of the matter until a problem is brought to his attention...Implicit is the additional duty to follow-up and review that delegated authority to ensure that it is being properly exercised.[58]

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[55] Exhibit 49 to Long's investigative testimony, January 22, 2021 (HORTER-SEC078355).

[56] Roth Expert Report, page 24.

[57] *Id.*, page 26.

[58] See my Expert Report, page 23, and *In the Matter of Rita H. Malm*, SEC Administrative Proceeding File No. 3-7679, November 23, 1994.

Thus, while Long and others who may very well have been qualified and capable of taking on the supervisory responsibility delegated to them by Horter, it was not appropriate for Horter to simply assume the delegated responsibilities were being properly carried out until he was advised otherwise. There is no evidence Horter ever took any affirmative steps to determine whether the responsibilities he delegated were being appropriately carried out.

In her Expert Report, Ms. Roth describes a specific example where the delegation of responsibilities failed because of the absence of any follow up. Ms. Roth states Jessica Vierling had been delegated responsibility for "the implementation and documentation of the third-party distribution procedures." Ms. Roth adds that Vierling "admitted to...instances in which she may have processed a distribution without adhering to the policy." Ms. Roth concludes:

> There is no evidence that Ms. Vierling ever told her supervisor (Kirk Horter or Mr. Hetzer), or Drew Horter for that matter that she did not adhere to the third-party distribution policies in strict compliance as was her duty.[59]

While it was reasonable for HIM and Horter to believe that Vierling would comply with HIM's policies and procedures regarding the processing of third-party disbursements (to the extent she understood them), it was not reasonable to simply assume she would fully comply with those procedures. Associated with the delegation of that responsibility to Vierling was the duty of HIM to confirm that Vierling was doing the job properly and in a manner consistent with the firm's policies and procedures. That did not happen even though, as Long noted, one of the benefits of the procedure was that it provided a mechanism for HIM's compliance department to review third-party disbursements.[60]

Ms. Roth's Expert Report appears to criticize Vierling for failing to tell her supervisor that she had not adhered to HIM's third-party distribution policies. Certainly, Vierling should have complied with those policies. The criticism, however, misses the key point, which is that HIM did nothing to confirm that Vierling was properly carrying out her job responsibilities. A firm cannot

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[59] Roth Expert Report, pages 42-44.

[60] See footnotes 17 and 18 above.

absolve itself of a supervisory failure because the employee or adviser representative it was responsible for supervising failed to report his/her non-compliance with firm policies or procedures. Reasonable supervision is intended to detect and address such failures.

Conclusions

Ms. Roth's Expert Report broadly suggests that HIM's compliance and supervisory systems were reasonable, that enhancements to those systems recommended by Oyster were "methodical and on-going," and that they satisfied the requirements of Rule 206(4)-7. She similarly described the scope of Hannan's on-boarding as "complete and robust" and she opined that Horter delegated supervisory authority to others "reasonably and effectively." I believe the evidence in this matter reflects just the opposite.

As directly related to this matter, HIM had no mechanism for detecting and preventing the conversion of client funds by one of its adviser representatives, Hannan. And Hannan was successful in converting funds through the use of *Distribution Requests* forms processed directly through HIM in the normal course of business.[61] Vierling, the person responsible for maintaining the *Log*, was never trained to look for questionable or suspicious transactions and no one in a supervisory capacity ever looked at the *Log* on which those disbursements were recorded with a view towards identifying transactions that might raise concerns (including payments to an entity that shared the same name as the adviser representative submitting the *Request* forms).

When Hannan was on-boarded with HIM, he disclosed several outside business activities. HIM took no steps to ascertain specifically what activity would be occurring through those entities. Additionally, no steps were taken to reconcile those outside business activities with the list of outside business activities Hannan had disclosed through LPL prior to joining HIM, one of which, Hannan Properties, was the entity through which Hannan converted client funds. Horter was aware of the existence of Hannan Properties but only made assumptions about its purpose.

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[61] In my experience, the conversion of client funds by representatives is usually done surreptitiously and in a way not easily detected. In this instance, Hannan did nothing to hide from HIM or Horter what he was doing. He used routine firm documents and processed each one consistent with firm normal processes.

Upon being surprised that Hannan was the subject of an inquiry by FINRA relating to the disclosures on Hannan's Form U5 from LPL (which would have been no surprise at all had a reasonable background check been done), HIM and Horter did nothing more than accept Hannan's self-serving explanation and chose simply to rely on FINRA to determine whether Hannan's conduct at LPL warranted sanctions. And while HIM chose to designate Hannan a "high risk" adviser representative, it did nothing to more closely scrutinize his activities or otherwise address the concerns that warranted the "high risk" designation.

After rejecting several requests from Hannan for HIM to financially support his new business venture, HR Resources, Hannan advised Horter that he would seek financial assistance "elsewhere." Horter assumed Hannan would look to the institutions that had supposedly agreed to partner with HR Resources for that financing but he never attempted to confirm that and never explored whether Hannan intended to, or did, solicit HIM clients for that financing.

Unquestionably, Hannan bears responsibility for his misconduct. However, neither that nor HIM's efforts to remind Hannan of his compliance obligations relieved HIM or Horter of their supervisory responsibilities with respect to Hannan. Similarly, while Vierling may have failed to fully comply with HIM policies regarding the processing of third-party disbursements from client accounts, that failure does not absolve HIM or Horter of the supervisory duties they had to verify that Vierling was doing her job completely and correctly. It is not reasonable for an investment advisory firm to rely on its adviser representatives or employees to supervise themselves.

There appears to be no dispute that Horter was ultimately responsible for supervising Hannan and HIM's other adviser representatives or that he delegated supervisory responsibility to others. He did nothing, however, to satisfy himself that those to whom he delegated supervisory responsibility were actually carrying out those responsibilities in a reasonable manner. Instead, he assumed those individuals would report to him any problems they had in carrying out their supervisory responsibilities and, absent that, would assume that all was well. The SEC has clearly stated that this is not sufficient.

The opinions set forth in this report are based on information and documents I have received to date. I reserve the right to modify, supplement, or otherwise amend this report and the opinions expressed herein if I am provided with any additional information or documentation regarding this matter.

Mainstay Capital Markets Consultants, Inc.

7-15-22

David E. Paulukaitis
Managing Director

Date